Tax Expenditures: Notes to the Estimates/ Projections

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Canada

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Distribution Centre
Department of Finance Canada
Room P-135, West Tower
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PREFACE

This is the inaugural edition of *Tax Expenditures: Notes to the Estimates/Projections*, the companion document to *Tax Expenditures and Evaluations*. This document sets out the approach used in developing the estimates and projections contained in the main report. It also provides a description and reports the objective of each tax expenditure.

Since neither the approach taken to developing the estimates and projections nor the description and objectives of most of the tax expenditures are likely to change from year to year, this report will be produced less frequently than the main report. Until now, the information in this report was published each year as part of the main report; the move to separate documents will make the main report easier to use.

The main report continues to provide estimates and projections for all tax expenditures. It also contains descriptive papers on a variety of issues, including selected measures announced in the recent budget. That document will continue to be published on an annual basis.

Chapter 1

Framework and Methodology

Tax expenditures are a subset of tax concessions that are used as alternatives to direct government spending for achieving government policy objectives. While there is general agreement on this conceptual definition of tax expenditures, there is no widely accepted operational methodology for estimating them. A range of methodologies exists internationally, some restrictive, others very broad. The broadest of the available options is to identify tax expenditures as all deviations from a benchmark tax system, and this is the approach used in this document. This option provides as much information as possible to the reader, without getting into a controversy as to whether or not an item is a tax expenditure.

In order to identify tax expenditures, it is necessary to establish a "benchmark" tax structure that does not contain any preferential tax provisions. Tax expenditures are then defined as deviations from this benchmark. It is important to recognize that reasonable differences of opinion exist as to the definition of the benchmark tax system, and hence what constitutes a tax expenditure. For example, child care expenses could be considered a cost of earning income and therefore part of the benchmark tax system; if not, then tax assistance for child care expenses would be a tax expenditure.

This report takes a broad approach – only the most fundamental structural elements of each tax system are considered to be part of the benchmark. By defining the benchmark in this manner, many tax provisions are treated as tax expenditures. This approach provides information on a full range of measures, and so allows readers who take a different position as to the appropriate benchmark system to construct their own list of tax expenditures.

In keeping with this objective of providing as much information as possible, this document identifies several tax provisions that are generally not considered to be tax expenditures even though they reduce the amount of revenue collected. These measures are denoted as "memorandum items" and have been included simply to provide additional information. Three types of memorandum items are included.

- Measures that are considered to be part of the benchmark system. The dividend tax credit, for example, reduces or eliminates the double taxation of income earned by corporations and distributed to individuals through dividends.
- Measures where there may be some debate over whether they should be considered tax expenditures. The cost of business-related meals and entertainment, for example, may be considered to be an expense incurred in order to earn income (and therefore part of the benchmark) or may be considered to provide a benefit (and therefore constitute a tax expenditure).
- Measures where the available data do not permit separation of the tax expenditure component from the portion that is essentially part of the benchmark tax system. For example, a portion of tax-free allowances for members of Parliament is used to cover legitimate expenses to earn income (and is therefore part of the benchmark for the income tax system) while the rest may be used for personal consumption

(and is therefore an income tax expenditure). Since it is not possible to distinguish between these two elements, the non-taxation of such allowances is included as a memorandum item.

The federal and provincial income tax and sales tax systems interact with each other to various degrees. As a result, changes to tax expenditures in the federal system may have consequences for provincial tax revenues. In this publication, however, any such provincial effects are not taken into account – that is, the tax expenditure estimates are purely federal in nature.

The remainder of this chapter discusses the tax expenditure concept in order to facilitate understanding of the quantitative estimates. It also discusses the calculation and interpretation of the costs of tax expenditures, including key assumptions used in the analysis.

Simplified descriptions of each tax expenditure as well as information on data sources and methodology used in constructing the estimates are presented in Chapter 2 (personal income tax), Chapter 3 (corporate income tax) and Chapter 4 (goods and services tax [GST]/harmonized sales tax [HST])[1].

Benchmark for Tax Expenditures in the Personal and Corporate Income Tax Systems

The benchmark for the personal and corporate income tax systems includes the existing tax rates and brackets, unit of taxation, time frame of taxation, treatment of inflation for calculating income and those measures designed to reduce or eliminate double taxation.

The definition of income is crucial in determining what constitutes a tax expenditure. Tax provisions that provide for the deduction of current costs incurred to earn income are considered to be part of the benchmark system and therefore not tax expenditures. For example, the deductibility of labour costs or economic depreciation of business assets in determining business income would not be considered a tax expenditure.

It is important to emphasize that the definition of the benchmark tax structure, and hence the identification of tax expenditures, is subjective. Reasonable differences of opinion may exist as to the interpretation and categorization of tax measures. For example, employment insurance (EI) premiums paid by an employee could be viewed either as an expense of earning income or as a tax used to finance an income transfer to the unemployed. From the first perspective, the current system of providing employees a tax credit for contributions would not be a tax expenditure. The credit for EI premiums merely recognizes an expense of earning income and, hence, is part of the benchmark tax structure. On the other hand, one could argue that the tax credit for EI contributions represents a tax expenditure because the taxes paid by taxfilers are generally not deductible against

[1] GST/HST is used throughout the publication as the HST replaced the GST in Nova Scotia, New Brunswick, and Newfoundland and Labrador on April 1, 1997. For the purposes of this publication, the HST represents only the federal component in the participating provinces (i.e., 7 per cent).

personal income taxes. For this reason the tax treatment of EI premiums is reported as a memorandum item. Measures such as these, which are subject to debate, are discussed on an individual basis as memorandum items in Chapters 2 and 3.

The following provides a more detailed discussion of the features of the benchmark for both the personal and corporate income tax systems.

(1) Tax Rates and Income Brackets

For the personal income tax system, the existing rate structure, including surtaxes, is taken to be part of the benchmark system. The basic personal credit is also treated as part of this structure since it is universal in its application and can be viewed as providing a zero rate of tax up to an initial level of income. However, the cost of this credit is included as a memorandum item.

With respect to the corporate income tax system, the benchmark is the basic federal corporate tax rate including the surtax and the provincial abatement. Provisions that reduce this tax rate for certain types of activities or corporations are regarded as tax expenditures. These include the low tax rate for manufacturing and processing profits and the low tax rate for small business profits. The large corporations tax, levied at the existing rate, is also considered to be part of the benchmark tax system.

(2) Tax Unit

Personal income taxes in Canada are based on individual income. Consequently, the individual is taken as the benchmark tax unit for the purposes of identifying tax expenditures in this report. This choice leads to the classification of the various provisions related to dependants, such as the spousal credit, as tax expenditures.

The choice of the appropriate unit for the corporate income tax benchmark system raises a number of conceptual issues. There is a wide range of possible tax units, including the establishment or activity unit within a corporation, the single legal corporate entity and the consolidated group of related corporations. The present income tax system contains elements of all these approaches. For example, the view that the activity unit is the appropriate unit of taxation is consistent with the "at-risk" rules, which restrict the amount of investment tax credits and business losses that may be flowed out to limited partners. The view that the single legal corporate entity is the relevant tax unit is supported by the fact that income from one part of a business can be offset by other business losses within the same corporation, whereas losses by one corporation may not generally be used against the income of another corporation in the group. Other provisions in the current tax system allow corporate groups to reorganize their corporate structures without triggering any capital gains or recaptured depreciation. These rollover provisions lead to a deferral of capital gains and recaptured depreciation, which would be appropriate if the taxation unit is the consolidated group of related corporations. On balance, the view most closely related to the existing system is that of the single legal corporate entity. For this reason, the single corporation is adopted as the benchmark tax unit, together with the availability of various rollover provisions that permit the deferral of capital gains when a corporate structure is changed.

(3) Taxation Period

The benchmark taxation period for the personal income tax system in this document is the calendar year. Accordingly, any measures that provide deferrals of taxable income to a subsequent year are considered to be tax expenditures. For example, farmers are permitted to defer the receipt of income from the sale of grain through the use of special cash purchase tickets, and this is listed as a tax expenditure.

The benchmark taxation period for the corporate income tax system is the fiscal year. As with the personal income tax system, deferrals, such as the accelerated write-off of capital assets, are considered to be tax expenditures.

A strict application of the annual taxation period would imply that measures that provide for the carry-over of losses to other years would be tax expenditures. However, the relatively cyclical nature of business and investment income suggests that such income should be viewed over a number of years. Consequently, carry-overs of losses are treated as part of the benchmark tax system in this report. These provisions are provided in the memorandum items section.

(4) Treatment of Inflation

Both the personal and corporate income tax systems are based on nominal income with a number of provisions that account for the impact of inflation. Nominal income is therefore taken as the appropriate basis for the benchmark tax system. Consequently, special measures, such as the partial exclusion of capital gains from taxable income, which may serve to recognize inflation, are identified as tax expenditures.

(5) Avoidance of Double Taxation

Conceptual difficulties arise in deciding whether certain provisions that reduce or eliminate double taxation should be considered as tax expenditures.

For example, regarding the personal and corporate income tax systems as completely separate would suggest that the dividend tax credit is a tax expenditure. However, the credit is an essential feature of the overall (i.e., both corporate and personal) income tax structure and serves to eliminate or reduce double taxation. In its absence, income earned through corporations would be taxed twice, once in the corporation and once at the personal level. For this reason, the dividend tax credit is not considered to be a tax expenditure.

Similarly, the non-taxation of intercorporate dividends is designed to ensure that income already taxed in one corporation is not taxed again upon receipt of a dividend by another corporation. Without this exemption, double taxation would occur and the corporate income tax system would not be neutral across organizational structures. For example, consider a single corporation that currently operates as a number of divisions. Now suppose it reorganizes into a holding company with wholly owned subsidiaries instead of divisions. The profits from the subsidiaries flow to the holding company through intercorporate dividends. If these dividends were subject to taxation at both the subsidiary and the holding company levels, double taxation would occur. Consequently, the exemption of inter-corporate dividends is not considered a tax expenditure.

Similar reasoning applies to the tax exemption on income of foreign affiliates of Canadian corporations. Canada either exempts certain dividend income paid by foreign affiliates from Canadian corporate income tax or it provides a foreign tax credit for income taxes paid in the other country. In either case, the intention is to ensure that income is not subject to double taxation (i.e., once in the country of residence of the foreign affiliate and once again in Canada when the dividends are paid out). A further discussion of this topic and the possible benchmarks that could be considered is contained in Chapter 3.

Information on some of the measures that provide relief from "double taxation" is provided in the appropriate memorandum sections of this report.

The Benchmark for the Income Tax System

The definition of the benchmark tax structure, and hence the identification of tax expenditures, is subjective. A broadly based system is used as the benchmark for income taxes in this report. The essential features are:

Personal Income Tax

- the existing tax rates and income brackets are taken as given;
- the tax unit is the individual;
- taxation is imposed on a calendar year basis;
- nominal income (i.e., no adjustment for inflation) is used in defining income; and
- it incorporates structural features of the overall tax system that reduce or eliminate double taxation, such as the dividend gross-up and credit.

Corporate Income Tax

- the existing general tax rate is taken as given;
- the tax unit is the corporation;
- taxation is imposed on a fiscal year basis;
- nominal income (i.e., no adjustment for inflation) is used in defining income; and
- it incorporates structural features of the overall tax system that reduce or eliminate double taxation, such as the non-taxation of intercorporate dividends.

Features of the GST/HST Benchmark[2]

The benchmark system used to analyze the GST/HST is a broadly based, multi-stage value-added tax collected according to the destination principle and using a tax credit mechanism to relieve the tax in the case of business inputs. The following provides a more detailed discussion of the features of the GST/HST benchmark.

(1) Multi-Stage System

The main structural elements of a multi-stage consumption tax are taken to be part of the benchmark. Under the multi-stage system, tax is applied to the sales of goods and services at all stages of the production and marketing chain. At each stage, however, businesses are able to claim tax credits to recover the tax they paid on their business inputs. In this way, the tax system has the effect of applying the tax only to the value added by each business. Since the only tax that is not refunded is the tax collected on sales to final consumers, the tax rests ultimately on final consumption.

(2) Destination-Based

The benchmark system applies tax only to goods and services consumed in Canada. Accordingly, the tax applies to imports as well as domestically produced goods and services. Exports are not subject to the tax.

(3) Single Tax Rate

The benchmark system has only one tax rate. This rate corresponds to the statutory rate of 7 per cent. As a result, GST/HST provisions that depart from this single rate are considered to be tax expenditures.

(4) Taxation Period

The benchmark taxation period is the calendar year.

(5) Constitutional Provisions for Government Sectors

Section 125 of the Constitution Act, 1867, provides that “no land or property belonging to Canada or any province shall be liable to taxation.” This means that neither the federal nor the provincial governments (or their Crown agents) are liable to taxation by the other. Accordingly, constitutional immunity from taxation is recognized as part of the benchmark system for the GST/HST.

The benchmark also recognizes that the federal and provincial governments have taken steps to simplify the operation of the tax for transactions involving government sectors.

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[2] It should be noted that this analysis deals only with the goods and services tax and harmonized sales tax and not with other commodity taxes (e.g., excise taxes). The exclusion of these other commodity taxes recognizes the inherent conceptual difficulties of defining an appropriate benchmark system in the context of a tax that is applied to a specific commodity. Work is continuing on defining an appropriate benchmark system that would allow the future measurement of the associated tax expenditures.

- The federal government decided to apply the GST/HST to purchases by federal departments and Crown corporations in order to keep the tax as simple as possible for vendors. As a result, the GST/HST and the benchmark system treat federal Crown corporations in the same manner as any other business entity.
- By virtue of Section 125, provincial governments and Crown agents are not liable to pay the GST/HST on their purchases. However, the federal government and most provinces have entered into reciprocal tax agreements. These agreements specify situations in which each level of government agrees to pay the sales taxes of the other, and generally this involves applying tax to purchases made by Crown corporations. As a result, provincial Crown corporations are treated like any other business entity in the benchmark system.

Unlike provincial governments, municipalities are liable to pay the GST/HST. Therefore, the benchmark system considers them as paying tax on their purchases. Universities, public colleges, schools and public hospitals are also considered to pay tax on their purchases. The GST/HST and the benchmark generally treat these sectors as final consumers – that is, they pay GST/HST on their purchases, they do not claim input tax credits and they do not collect GST/HST on their sales.

The only exception to this benchmark treatment arises from the fact that municipalities, universities, public colleges, schools and public hospitals engage in certain commercial activities analogous to those provided in the private sector. For example, some municipalities operate golf courses. Such commercial activities are taxable under the GST/HST, and the GST/HST paid on associated inputs can be claimed as input tax credits.

The Benchmark for the GST/HST

The essential features are:

- basic structural features of a broadly based, multi-stage tax system;
- destination approach;
- 7-per-cent rate;
- calendar year basis for the taxation period; and
- recognition of constitutional provisions for government sectors.

Types of GST/HST Tax Expenditures

Comparing the actual structure of the GST/HST to the benchmark system, it is possible to identify four types of tax expenditure:

- zero-rated goods and services;
- tax-exempt goods and services;
- tax rebates; and
- the GST/HST credit.

(1) Zero-Rated Goods and Services

Under the GST/HST, certain categories of goods and services are taxed at a "zero" rate, rather than at the general tax rate of 7 per cent. Vendors do not charge GST/HST on their sales of zero-rated goods and services (whether these sales are to other businesses or to final consumers). However, vendors are entitled to claim input tax credits to recover the GST/HST they paid on inputs used to produce zero-rated products. As a result, zero-rated goods and services are tax-free.

One category of zero-rated sales is basic groceries – i.e., foods intended to be prepared and consumed at home. Other categories of zero-rated sales include prescription drugs, medical devices and most agricultural and fish products.

(2) Tax-Exempt Goods and Services

Some types of goods and services are exempt under the GST/HST. This means that the GST/HST is not applied to these sales. Unlike zero-rated goods and services, however, vendors of exempt products are not entitled to claim input tax credits to recover the GST/HST they paid on their inputs to these products.

Examples of tax-exempt goods and services include long-term residential rents, most health and dental care services, day-care services, most sales by charities, most domestic financial services, municipal transit and legal aid services.

(3) Tax Rebates

Certain sectors are eligible for rebates on a portion of the GST/HST paid on inputs. For example, there are rebates for schools, universities, public colleges, public hospitals and municipalities. To the extent that these sectors make taxable sales, they can claim input tax credits to recover the tax they paid on inputs to these sales. Where they provide tax-exempt services, however, they are eligible to receive rebates for only a portion of the GST/HST paid on their inputs to these services. These rebates ensure that these institutions do not bear a greater tax burden on their purchases under the GST/HST than they would have under the manufacturers' sales tax, which the GST/HST replaced. This treatment constitutes a tax expenditure because, under the benchmark system, these institutions are considered to be final consumers.

Other examples of tax rebates include the rebates for charities, substantially government-funded non-profit organizations, newly built housing, new residential rental property and book purchases made by qualifying institutions. Also, foreign visitors to Canada are able to claim a rebate for the GST/HST they pay on hotel accommodation and on goods they take home. Only the rebate for hotel accommodation is considered to be a tax expenditure, however, because goods taken home by foreign visitors are effectively exports, which are not taxable under the benchmark system.

(4) GST/HST Credit[3]

To ensure that the GST/HST system is fair, a GST/HST credit is provided through the personal income tax system to single individuals and families with low and moderate incomes. The credit is paid by cheque four times a year in equal instalments. The total amount of the credit depends on family size and income and is calculated annually based on information provided in personal income tax returns.

GST/HST Tax Expenditures:

- zero-rated goods and services;
- tax-exempt goods and services;
- tax rebates; and
- the GST/HST credit.

Memorandum Items for the GST/HST

As indicated earlier, some tax measures are presented as memorandum items even though they are not generally considered to be tax expenditures. For example, the refund of GST/HST for certain employees' expenses is included as a memorandum item.

Many employees, such as commission salespeople, incur significant expenses in the course of carrying out their duties. Examples include restaurant meals and automobile expenses. Often, such expenses are not reimbursed by employers except indirectly through the salaries and commissions paid to employees. Since employees are not considered to be carrying on a commercial activity, they are not able to claim input tax credits for the GST/HST they paid on these expenses. However, employees can receive a refund of the GST/HST paid on those employment expenses that are deductible for income tax purposes. The refund of GST/HST paid on employees' personal consumption expenses would constitute a tax expenditure. However, it is not possible to determine exactly what portion of these expenses should be considered personal consumption. Therefore, the refunds of GST/HST paid on employees' expenses are reported as memorandum items. The memorandum items for the GST/HST are discussed in more detail in Chapter 4.

Calculation and Interpretation of the Estimates

The estimates indicate the annual cash-flow impact to the Government of each measure, and not their long-run or steady-state revenue cost, subject to the following limitations:

- all measures are evaluated independently; and
- all other factors remain unchanged.

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[3] It should be noted that there was a small business transitional credit that accompanied the introduction of the GST. This temporary measure provided a one-time credit of up to $1,000 to registrants whose taxable sales did not exceed $500,000 in their first full quarter of 1991 or in any three-month period beginning in 1990.

These methodological distinctions are important and have implications for the interpretation of the estimates. These concepts are discussed in further detail below.

Independent Estimates

The estimate of the cost of each tax expenditure is undertaken separately, assuming that all other tax provisions remain unchanged. An important implication of this is that the estimates cannot be meaningfully aggregated to determine the total cost of a particular group of tax expenditures or of all tax expenditures combined.

As explained in more detail in the following paragraphs, this restriction arises from the fact that:

- the income tax rate structure is progressive; and
- tax measures interact with one another.

Progressive Income Tax Rates

The combined effect of claiming a number of income tax exemptions and deductions may be to move an individual to a lower tax bracket than would have applied had none of the tax measures existed. To the extent that this occurs, aggregation of the individual estimates may under-represent the "true" cost to the federal government of maintaining all of them. For example, consider a taxpayer whose taxable income was $1,000 below the level at which he or she would move from the 17-per-cent into the 26-per-cent tax bracket. Imagine that this taxpayer arrives at this level of taxable income by using two tax deductions of $1,000 each (e.g., the deduction for home relocation loans and for registered retirement savings plan [RRSP] contributions). Eliminating either deduction by itself would increase taxable income by $1,000 and the taxpayer's federal tax liability by $170. Eliminating both measures simultaneously, however, would not raise the tax liability by $170 + $170, but rather by $170 + $260.

Aggregating the individual estimates for these two items would provide a misleading impression of the revenue impact of eliminating both of them. Therefore, the estimates in this document cannot be meaningfully aggregated to determine the total cost of a particular group of tax expenditures or of all tax expenditures combined.

While there is only one statutory tax rate for corporations, the various tax rate reductions create a de facto progressive tax rate schedule for some corporations. In this way, the above argument is valid for the corporate income tax system as well, although the effect is not as large as for personal income taxes.

Interaction of Tax Measures

As noted above, the estimates are computed one at a time, assuming all other provisions remain unchanged. Given that tax provisions sometimes interact, the total cost of a group of tax expenditures calculated individually may differ from the dollar value of calculating the cost of the same group of tax expenditures concurrently. This is because adding the independently estimated costs of the tax provisions would result in double counting and so would not provide an accurate measure of the revenue that would be generated by simultaneously altering a group of measures.

For example, consider the non-taxation of veterans' allowances, which reduces the recipient's net income. Many measures, such as the medical expense tax credit, are calculated on the basis of net income. Thus, the reported estimate for the non-taxation of veterans' allowances represents not only the direct impact on government receipts of not taxing the allowances, but also the indirect impact of the change on the cost of other tax measures (such as the medical expense tax credit) that depend on net income.

Since estimates for GST/HST tax expenditures are made using the same methodological approach as for income taxes, they too cannot be aggregated because they may interact. The following discussion of hospital rebates and zero-rating of prescription drugs illustrates the differences between independent and concurrent estimates for these two provisions.

- Eliminating hospital rebates: If hospital rebates were eliminated, hospitals would no longer be able to recover 83 per cent of the GST/HST they pay on their purchases.[4] However, they could continue to purchase prescription drugs on a tax-free basis because these drugs are zero-rated. The estimate for hospital rebates recognizes that the rebate would not have been claimed in respect of zero-rated prescription drugs.
- Eliminating the zero-rating of prescription drugs: If prescription drugs were taxed at the GST/HST rate of 7 per cent, then hospitals would pay the tax on their drug purchases but recover 83 per cent of the tax through the rebate system. Therefore, the estimate for the zero-rating of prescription drugs is calculated as net of the expected increase in the payment of hospital rebates.
- Eliminating the two measures concurrently has a revenue impact greater than the sum of the independent estimates because the GST/HST would be payable on prescription drugs and hospitals would be unable to claim a rebate for these purchases.

Aggregation of Estimates

The estimates for individual tax expenditures cannot be added together to determine the cost of a group of tax expenditures. There are two reasons for this:

- the simultaneous elimination of more than one income tax expenditure would generate different estimates because of progressive income tax rates; and
- given the interaction of certain tax measures, the revenue impact of eliminating two or more measures simultaneously would differ from taking the independently estimated numbers published in this document and simply aggregating them.

[4] Most services provided by hospitals are exempt from the GST/HST. This means that no tax is charged on these services but input tax credits cannot be claimed to recover the tax paid on inputs. However, hospitals are able to claim a rebate of 83 per cent of the GST/HST paid on the inputs they use to provide exempt services.

All Other Factors Remain Unchanged

The estimates in this report represent the amount by which federal tax revenues were reduced due to the existence of each preference, assuming that all other factors remain unchanged.

In order to evaluate the extent of the revenue reduction, the approach taken here is to recalculate federal revenues assuming the measure in question has been eliminated. The difference between this recalculated figure and actual revenues provides the quantitative estimate of the cost of the tax expenditure.

The assumption that all other things remain the same means that no allowance is made for: (i) behavioural responses by taxpayers; (ii) consequential government policy changes; or (iii) changes in tax collections due to altered levels of aggregate economic activity which might result from the elimination of a particular tax measure (further detail is provided below). Incorporating these factors would add a large subjective element to the calculations.

(1) Absence of Behavioural Responses

In many instances, the removal of a tax expenditure would cause taxpayers to rearrange their affairs to minimize the amount of extra tax they would have to pay, perhaps by making greater use of other tax measures. Therefore, the omission of behavioural responses in the estimating methodology generates cost estimates that may exceed the revenue increases that would have resulted if a particular provision had been eliminated.

As one example, consider the case of the deduction for RRSP contributions. Eliminating this provision would result in the amount of additional federal revenue indicated in the report only if the contributions were not directed to an alternative tax-preferred form of saving. However, the absence of the RRSP deduction might encourage individuals to place their funds instead in some other tax-favoured instrument, such as shares in a labour-sponsored venture capital corporation. If such a response did occur, eliminating the RRSP deduction would result in a smaller increase in revenues than that indicated.

The effects of this assumption can also be illustrated for the GST/HST by considering the housing rebate. Homeowners are eligible for a rebate of the GST/HST they pay on the purchase of new houses. If this rebate were eliminated, the price of new houses would increase relative to the price of used houses. This, in turn, might reduce the demand for new houses while increasing the demand for used houses (which are tax-exempt). Since the dynamics of the housing market are not taken into account, the revenues obtained by eliminating the housing rebate could actually be lower than the indicated estimate.

(2) Consequential Government Policy Changes

The estimates ignore transitional provisions that might accompany the elimination of a particular measure and take no account of other consequential changes in government policy. For example, if the Government were to eliminate a particular tax deferral, it could require the deferred amount to be brought into income immediately.

Alternatively, it might prohibit new deferrals but allow existing amounts to continue to be deferred, perhaps for a specified period of time. The estimates in this report do not provide for any such transitional relief.

Similarly, the estimates make no allowance for consequential government policy changes. For example, if capital gains on owner-occupied housing were made taxable under the personal income tax system, an argument could be made that the cost of maintenance should be deductible in the same way as other investment expenses.

(3) Impact on Economic Activity

The estimates do not take into account the potential impact of a particular tax provision on the overall level of economic activity and thus aggregate tax revenues. For example, although eliminating the low corporate tax rate for manufacturing and processing could generate a significant amount of revenue for the Government, the amount of manufacturing activity could decline. That in turn could cause job losses, a reduction in taxable income and, hence, a reduction in the aggregate amount of tax revenue collected. Furthermore, the derivation of the estimates does not include speculation on how the Government might use the additional funds available to it and the possible impacts this could have on other tax revenues.

How to Interpret the Estimates

Each estimate in this report represents the amount by which federal tax revenues were reduced due to the tax expenditure assuming that all other factors remain unchanged. The estimates do not take into account changes in taxpayer behaviour, consequential government actions or feedback on aggregate tax collections through induced changes in economic activity. Accordingly, the elimination of a tax expenditure would not necessarily yield the full tax revenues shown in *Tax Expenditures and Evaluations*.

Developing Historical Estimates

The majority of the personal income tax estimates in this report were computed with a personal income tax model. This model simulates changes to the personal income tax system using the statistical sample of tax returns collected by the Canada Customs and Revenue Agency (CCRA) for its annual publication *Tax Statistics on Individuals*. The model estimates the revenue impact of possible tax changes by recomputing taxes payable on the basis of adjusted values for all relevant income components, deductions and credits. For example, the removal of the moving expense deduction would result not only in a change in net income but also in all of the credits, such as the medical expense tax credit, whose values depend on net income. For those tax expenditures whose costs could not be estimated using this model alone, supplementary data were acquired from a variety of sources. Details on data sources and the methodologies used for estimating the cost of specific personal income tax measures are provided in Chapter 2.

A corporate income tax model was used to measure most of the corporate tax expenditures. As with the personal income tax model, it is based on a statistical sample of tax returns collected by the CCRA and is able to recompute taxes payable on the basis of adjusted tax provisions. This recomputation of taxes takes into account the availability

of unused tax credits, tax reductions, deductions and losses that would be used by corporations to minimize their tax liability. Where costs could not be estimated using this model alone, supplementary data acquired from a variety of sources were used. Details on these sources are provided in Chapter 3.

Estimating the cost of tax deferrals presents a number of methodological difficulties since, even though the tax is not currently received, it may be collected at some point in the future. It is therefore necessary to derive estimates of the cost to the Government of providing such a tax deferral while at the same time ensuring comparability with the other estimates presented here. In this report, income tax deferrals are estimated on a "current cash-flow" basis – that is, the cost is computed as the forgone tax revenue associated with the additional net deferral in the year (deductions for the current year less the income inclusion from previous deferrals). The estimates thus computed provide a reasonably accurate picture of the ongoing costs of maintaining a particular tax provision in a mature tax system. They can be aggregated over time without double counting and are comparable to estimates of the costs associated with tax credits and deductions.

The costs of the majority of the GST/HST tax expenditures presented in this report were estimated using a Sales Tax Model based on Statistics Canada's Input-Output Tables and the National Income and Expenditure Accounts. In cases where estimates were not derived using this model, supplementary data from a variety of sources were used. Details on both the data sources and methodologies are provided in Chapter 4.

Developing Future Projections

As with the historical estimates, the projections represent the estimated amount by which the federal tax revenues would be reduced due to the tax expenditure, assuming that all measures are evaluated independently. This means that the projections cannot be aggregated. In addition, it is assumed that all other factors remain unchanged. Thus, the projections make no provision for any behavioural change that might result from the removal of the provision; for any consequential policy changes that might accompany the change; or for the possible impact of the change on overall economic activity and thus on tax revenues. The projections do, however, take into consideration the impact of announced tax changes.

In contrast to the estimates of tax expenditures for the historical period, when values of the tax expenditures can generally be obtained from tax statistics or other historical data, projections of tax expenditures must rely on estimated relationships between tax expenditures and explanatory economic variables. Using these relationships, the values for the explanatory variables are projected into the future and so permit an estimation of the future expected values of tax expenditures. Key explanatory variables are generally those reflecting the state of the economy.

Projections for the explanatory variables are based on either the 2000 budget forecasts (e.g., gross domestic product [GDP], population, employment, corporate profits, inflation and consumer spending) or on past trends in the tax expenditure. Where projected tax expenditures were not obtained using these approaches, information on the alternative methodology is provided in Chapter 2 for personal income tax, Chapter 3 for corporate income tax and Chapter 4 for GST/HST tax expenditures.

Any projections are inherently subject to forecast error and quite substantial errors at times. Analysts familiar with forecasts prepared for the Canadian economy, or for any other economy, recognize that forecasting is not a science. Future values for key explanatory variables are based on best judgements, and unchanged policies are assumed for the forecast period. Furthermore, the relationships between variables that are being explained and those that provide the explanation may not be robust and could quickly change over time. For all these reasons, the projected values of tax expenditures should be treated as "best efforts" that do not have any greater degree of reliability than the variables that explain them. For example, if the level of GDP explains a tax expenditure, one would not expect the projected level of tax expenditure to materialize if the expected level of GDP did not occur. Even if the expected level of GDP did materialize, the level of the tax expenditure might not if, in the future, the relationship between the tax expenditure and GDP turns out to be different from that estimated on average in the past. Therefore, in general, one should expect that the degree of reliability of the projected tax expenditures should be less than that of the underlying explanatory variables.

Comparison With Direct Expenditures

In comparing the cost of the tax expenditures in this report to direct spending estimates, it should be noted that a dollar of tax preference is often worth substantially more to the taxpayer than a dollar of direct spending. This results from the fact that, in most cases, government grants (i.e., direct spending) are taxable to the recipients. For example, consider an individual facing a marginal tax rate of 29 per cent. A deduction of $100 would be worth $29. If, instead, the Government were to provide the individual with a taxable grant of $29, after-tax income would increase by only $20.59 since the individual would face an income tax liability of $8.41 ($29 x 29 per cent).

The same conclusions do not always apply to tax expenditures provided to corporate taxpayers. Consider, for example, an investment tax credit to a corporation with respect to capital equipment acquired to carry out scientific research and experimental development in Canada. The cost to the Government of providing a 20-per-cent tax credit would, in most circumstances, be the same as it would be if the Government had provided a direct grant of 20 per cent. This is because investment tax credits are considered to be assistance and are therefore treated in the same manner as direct government grants or subsidies. The 20-per-cent tax credit, like a direct grant, is either included in income and subject to corporate income tax or it reduces the capital or other costs deductible by the taxpayer.

Chapter 2

Description of Personal Income Tax Provisions

Culture and Recreation

Deduction for Clergy Residence

> ***Objective:*** *The special treatment of clergy housing expenses recognizes the special nature of the contributions and circumstances of members of the clergy. (Budget Speech, March 1949.)*

A taxpayer who is a full-time member of the clergy or a regular minister of a religious denomination may deduct housing costs from income for tax purposes. Where a member of the clergy is supplied living accommodation by his/her employer or receives housing allowances, an offsetting deduction may be claimed to the extent that this benefit is included in income. The estimate for this item is based on the number of clergy in Canada and Statistics Canada expenditure data on rent.

Flow-Through of Capital Cost Allowance on Canadian Films

> ***Objective:*** *To assist the financing and development of the Canadian film industry, until 1995 the tax law provided a special write-off for investment in certain Canadian motion picture films or videotapes certified by the Secretary of State. After 1995, this provision was replaced with a tax credit to producers in order to maximize the benefit to eligible productions. (Budget Plan, 1995.)*

Prior to 1995, the capital cost allowance (CCA) rate generally available on films was 30 per cent, subject to the half-year rule. On Canadian content films, the half-year rule did not apply. The CCA could be flowed through to investors and deducted against all sources of income. An additional allowance of up to the remaining undepreciated capital cost of the film was deductible against an investor's income from certified Canadian films.

Losses arising from CCA claimed at the partnership level and flowed through as limited partnership losses are included in the "deduction of limited partnership losses" tax expenditure. It is estimated that 15 per cent of limited partnership losses relate to CCA on Canadian films.

The 1995 budget replaced the special tax shelter rules that applied to Canadian content films by a 12-per-cent credit that can be claimed only by certain film and video production corporations. Transitional rules for the 1995 taxation year allowed full deductibility of undepreciated capital cost against film income and the flow-through of the CCA to the investor only if the 12-per-cent refundable tax credit was not claimed in respect of the production.

Deduction for Certain Contributions by Individuals Who Have Taken Vows of Perpetual Poverty

> ***Objective:*** *This measure recognizes the special situation of members of religious orders. (Section 110(2), Income Tax Act, Charitable gifts.)*

Where a person has taken a vow of perpetual poverty as a member of a religious order, that person may deduct donations to the religious order up to his/her total employment and pension income (but not investment or other income) in lieu of the charitable donations credit.

Write-off of Canadian Art Purchased by Unincorporated Businesses

> ***Objective:*** *The special capital cost allowance claim for Canadian art is intended to further the dissemination of Canadian art, as well as to support Canadian artists. (Budget Papers, 1981).*

Canadian art acquired by businesses for display in an office may be depreciated on a 20-per-cent declining-balance basis even though it may depreciate at a much slower rate, and may even appreciate.

No data are available.

Assistance for Artists

> ***Objective:*** *The special treatment of costs incurred by artists recognizes artists' problems in valuing their works of art on hand, attributing costs to particular works, and carrying inventories over long periods of time. The special election with respect to a charitable gift from an artist's inventory removes an obstacle to artists donating their works of art to charities, public art galleries and other public institutions. (Budget Papers, 1985).*

Artists may deduct the costs of creating a work of art in the year the costs are incurred rather than in the year the work of art is sold.

Artists may also elect to value a charitable gift from their inventories at any amount up to its fair market value. This value is included in the artist's income. The percentage of income limit for the charitable donations tax credit does not apply.

No data are available.

Deduction for Artists and Musicians

> ***Objective:*** *The deductibility of certain expenses incurred by artists and musicians recognizes that these expenses are necessary to carry on employment in those fields. (Musical instruments: Income Tax Reform, 1987.*
> *Artists' employment expenses: Section 8(1)(q), Income Tax Act. The latter was added in 1991, for expenses incurred after 1990.)*

Employed musicians are able to claim the cost of maintenance, rental, insurance and capital cost allowance on musical instruments against employment income earned as a musician. Employed artists are also entitled to deduct expenses related to their artistic endeavours up to the lesser of $1,000 or 20 per cent of their income derived from employment in the arts.

No data are available.

Non-Taxation of Capital Gains on Gifts of Cultural Property

> ***Objective:*** *This provision encourages the donation to designated institutions (such as museums and art galleries) of cultural property determined to be of outstanding significance to Canada's national heritage. (Budget Plan, 1998.)*

Certain objects certified as being of cultural importance to Canada are exempt from capital gains tax if donated to a designated museum or art gallery. Such donations amounted to $99 million in 1995, $78 million in 1996, and $111 million in 1997. However, there is no information on the portion of the value that represents capital gains.

Education

Tuition Fee Credit

> ***Objective:*** *This measure provides tax relief to students (and their parents) by recognizing the costs of enrolling in qualifying programs or courses.*
> *(Budget Speech, September 1960.)*

A 17-per-cent tax credit is available for tuition fees paid by students to a prescribed educational institution. A credit is available with respect to fees paid to an institution if the total tuition fees paid to the institution exceed $100. The 1997 budget extended the credit to most mandatory ancillary fees imposed by post-secondary institutions, starting in 1997.

Education Credit

> ***Objective:*** *This measure provides assistance to students by recognizing non-tuition costs associated with full- and part-time education.*
> *(Budget Supplementary Information, 1972)*

Students who are enrolled at prescribed educational institutions on a full-time basis are entitled to claim a tax credit of 17 per cent of an education amount. The amount was $80 for every month of full-time attendance for 1994 and 1995, $100 for 1996, $150 for 1997 and $200 for 1998 and subsequent taxation years. The 1998 budget extended this tax relief to part-time students for 1998 and subsequent years. Students enrolled at an educational institution in Canada in an eligible program lasting at least three consecutive weeks and involving a minimum of 12 hours of courses each month will be eligible. For each qualifying month, the education amount is $60 per month, on which the 17-per-cent tax credit is provided.

Education and Tuition Fee Credits Transferred

Objective: *This measure increases the availability of tax assistance for education, and acknowledges the significant contributions made to students by supporting individuals. (Income Tax Reform, 1987.)*

The unused portions of the education and the tuition fee amounts may be transferred to a supporting spouse, parent or grandparent. The maximum transfer for the two amounts combined was $4,000 for taxation years 1994 and 1995 and $5,000 for 1996 and subsequent taxation years.

Carry-Forward of Education and Tuition Fee Credits

Objective: *Combined with the provision for transfer of tuition and education credits, this measure ensures that students can use these credits fully, whether they have supporting individuals or not. (Budget Plan, 1997.)*

The 1997 budget allowed students to carry forward indefinitely for their own use education and tuition fee amounts that have not been either already used by the student or transferred to a supporting individual, effective in 1997.

Student Loan Interest Credit

Objective: *This measure was introduced in the 1998 budget in recognition of the costs of investment in higher education, and to help ease the burden of student loans. (Budget Plan, 1998.)*

In order to ease the burden of student debt, the 1998 budget introduced a 17-per-cent tax credit on the interest portion of student loan payments made in a year for 1998 and subsequent years. The credit, which is available in respect of payments under the Canada Student Loan Program and similar provincial programs, may be claimed in the year in which it is earned or in any of the subsequent five years.

Registered Education Savings Plans

Objective: *Tax assistance for education savings plans broadens access to higher education by encouraging Canadians to save towards the post-secondary education of children. (Budget Plan, 1998.)*

A taxpayer may contribute to a registered education savings plan (RESP) on behalf of a designated beneficiary (usually the taxpayer's child). Contributions to RESPs are not deductible, but are usually returned to the subscriber free of tax. The investment return on these funds is not taxable until they are withdrawn for the education of the named beneficiary. This tax deferral constitutes the tax expenditure associated with RESPs. In 1994 and 1995, the annual contribution could not exceed $1,500 per beneficiary, with an overall lifetime limit of $31,500 per beneficiary. Effective in 1996, the annual limit was increased to $2,000 with a lifetime limit of $42,000. In 1997, the annual limit was increased to $4,000.

Starting in 1998, RESP contributors are allowed, under certain conditions, to receive investment income from their plan either directly or through their registered retirement savings plans (RRSPs) where beneficiaries of the plan do not pursue higher education. The income received directly is subject to regular tax plus a deferral tax of 20 per cent while the amount transferred to an RRSP is subject to available RRSP room as well as lifetime limitations. Prior to 1998, RESP income could be used only for educational purposes.

Effective in 1998, the Government supplemented contributions to RESPs with a 20-per-cent grant (the Canada Education Savings Grant [CESG]), subject to annual and lifetime limitations. While this enhancement does not directly represent a tax expenditure, the grant increases the cost of the tax expenditure to the extent that it encourages increased use of RESPs.

Estimates are based on the data and projections provided by the CESG program. No data are available for years prior to 1996.

Partial Exemption of Scholarship, Fellowship and Bursary Income

> ***Objective:*** *This measure provides additional tax assistance to students. (Summary of 1971 Tax Reform Legislation, 1971).*

From 1972 to 1999, the first $500 of scholarship, fellowship and bursary income was exempt from income tax. The 2000 budget proposed to increase this tax exemption to $3,000 for students eligible for the education credit. The tax expenditures reported in the table are understated since no data are available on individuals receiving scholarship, fellowship or bursary income of less than $500.

Deduction of Teachers' Exchange Fund Contributions

> ***Objective:*** *This measure encourages contact with educators in other Commonwealth countries, thereby expanding the scope of the educational experience of Canadian students and encouraging the exchange of information on modern teaching methods. (Budget Speech, 1957.)*

Teachers may deduct up to $250 per year in contributions to a fund established by the Canadian Education Association for the benefit of teachers from Commonwealth countries visiting Canada under a teachers' exchange agreement.

Employment

Deduction of Home Relocation Loans

> ***Objective:*** *This deduction is intended to facilitate labour mobility by allowing employers to compensate relocated employees facing higher housing costs at the new location. (Budget Papers, 1985.)*

An offsetting deduction from taxable income is provided for the benefit received by an employee in respect of a home relocation loan. The amount of the deduction is the lesser of the amount included in income as a taxable benefit and the amount of the benefit that would arise in respect of a five-year interest-free loan of $25,000.

Non-Taxation of Allowances for Volunteer Firefighters

> ***Objective:*** *The tax-free allowance for volunteer firefighters acknowledged the importance of these volunteers to small and rural communities. (Budget Plan, 1998.)*

Volunteer firefighters were eligible to receive up to $500 per year in non-taxable allowances. The 1998 budget replaced this measure with an exemption of up to $1,000 for amounts received by emergency service volunteers.

The estimates are based on census data.

Tax-Free Amount for Emergency Service Volunteers

> ***Objective:*** *This measure was introduced in the 1998 budget to further support small and rural communities, which are often unable to maintain full-time emergency staffs and depend on the services of volunteers. (Budget Plan, 1998.)*

The 1998 budget provided an exemption of up to $1,000 for amounts received by emergency service volunteers who, in their capacity as volunteers, are called upon to assist in emergencies or disasters.

Northern Residents Deductions

> ***Objective:*** *These tax preferences assist in drawing skilled labour to northern and isolated communities by providing recognition for the additional costs faced by residents of these areas. (Budget Papers, 1986.)*

Individuals living in prescribed areas in Canada for a specified period may claim the northern residents deductions. The benefits consist of a residency deduction of up to $15 a day, a deduction for two employer-provided vacation trips per year and unlimited employer-provided medical travel. Residents of the Northern Zone are eligible for full benefits, while residents of the Intermediate Zone are eligible for 50 per cent of the benefits.

Overseas Employment Credit

> ***Objective:*** *This measure ensures the competitive international position of Canadian companies undertaking work outside Canada on specified business activities by offering tax treatment comparable to that provided by other countries. (Budget Papers, 1983.)*

A tax credit is available to Canadian employees working abroad for more than six months in connection with certain resource, construction, installation, agricultural or engineering projects. The credit is equal to the tax otherwise payable on 80 per cent of the employee's net overseas employment income taxable in Canada, up to a maximum income of $80,000.

Employee Stock Options

> ***Objective:*** *This measure encourages employee participation in the ownership of the employer's business, and assists businesses in their efforts to attract and retain highly skilled employees. (Budget Documents, 1977.)*

Provided certain conditions are met, the benefit provided by an employee stock option is taxed at a preferential rate. A deduction is available to partly offset the tax liability on the stock option benefit. The 2000 budget proposed that this deduction be increased from one-quarter to one-third of the stock option benefit, effective February 28, 2000.

For employees of Canadian-controlled private corporations (CCPCs), the stock option benefit is included in income when the share acquired with the option is disposed of. The 2000 budget proposed that similar treatment be available for employees of publicly traded companies who exercise options after February 27, 2000, on up to $100,000 in options that vest each year. For other options granted by non-CCPCs, the stock option benefit is included in income when the option is exercised.

Estimates presented in the table reflect the stock option deduction, but not the deferred income inclusion for certain stock option benefits.

Non-Taxation of Strike Pay

> ***Objective:*** *Strike pay is non-taxable by virtue of the Supreme Court of Canada's determination that it is not income from a source.* (Wally Fries v. The Queen, *(1990) 2 CTC 439, 90 DTC 6662. Canada Customs and Revenue Agency, IT-334R2 Miscellaneous Receipts.)*

Strike pay is non-taxable.

Statistics Canada has ceased collecting information on the amount of strike pay.

Deferral of Salary Through Leave of Absence/Sabbatical Plans

> ***Objective:*** *This provision recognizes that the main purpose behind these plans is to provide in advance for extended leaves of a sabbatical nature within the employment relationship, and not the deferral of taxes. (Budget Papers, 1986.)*

Employees may be entitled to defer salaries through a leave of absence/sabbatical plan. Provided certain conditions are met by the plan, these amounts are not subject to tax until received.

No data are available.

Employee Benefit Plans

> ***Objective:*** *The scope of tax-deferred salary arrangements was significantly reduced in 1986 to improve the fairness of the distribution of tax benefits to individuals in different employment situations. The preferential tax treatment under these plans is now available only in certain circumstances where an employee's right to income under a plan has not been fully earned, or where the main purpose behind the plan is to provide incentives and not the deferral of tax. (Budget Papers, 1979 and 1986.)*

In certain circumstances, employers may make contributions to an "employee benefit plan" on behalf of their employees. The employee is not required to include in income the contributions to the plan or the investment income earned within the plan until amounts are received. Employers may not deduct these contributions to the plan until these contributions are actually distributed to the employees.

No data are available.

Non-Taxation of Certain Non-Monetary Employment Benefits

> ***Objective:*** *This treatment recognizes the significant administrative and compliance costs that would be incurred in taxing non-monetary employment benefits.*

Fringe benefits provided to employees by their employers are not taxed when it is not administratively feasible to determine the value of the benefit. Examples include merchandise discounts, subsidized recreational facilities offered to all employees and special clothing.

No data are available.

Family

Spousal Credit

> ***Objective:*** *This credit recognizes that a taxpayer whose spouse has little or no income has a lesser ability to pay tax than a single taxpayer with the same income.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

A taxpayer supporting a spouse is entitled to a tax credit of 17 per cent of the spousal amount. Prior to 1999, this amount was $5,380, and the credit was reduced by the dependent spouse's income above $538. The 1999 budget increased the maximum credit to 17 per cent of $6,055, and raised the threshold at which the credit amount begins to be reduced to $606, effective July 1, 1999. The 2000 budget proposed to fully index the spousal amount and the net income threshold by the rate of inflation effective January 1, 2000. Full indexation will increase the spousal credit to 17 per cent of $6,140 and will raise the threshold at which the credit amount begins to be reduced to $614 for the 2000 taxation year.

Equivalent-to-Spouse Credit

> ***Objective:*** *This credit recognizes that a taxpayer without a spouse who is supporting a dependent young child, parent or grandparent has a lesser ability to pay tax than a taxpayer with the same income and no such dependant.*
> *(Section 118(1)(b), Income Tax Act, Wholly dependent person.)*

An "equivalent-to-spouse" tax credit may be claimed in respect of a dependent child under age 18 or a parent or grandparent by taxpayers without a spouse. The amounts of the credit and limitation on the dependant's income are the same as for the spousal credit. The 2000 budget proposed to fully index these amounts effective January 1, 2000.

Infirm Dependant Credit

> ***Objective:*** *This credit recognizes that a taxpayer supporting an adult dependant who is physically or mentally infirm has a lesser ability to pay tax than a taxpayer with the same income and no such dependant.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

For the taxation year 1995, taxpayers could claim the infirm dependant credit for dependent relatives over 17 years of age who were physically or mentally infirm. The credit was 17 per cent of $1,583 for dependants whose income was below $2,690. The credit was reduced by 17 per cent of the dependant's net income in excess of that amount and was reduced to zero when the dependant's net income exceeded $4,273.

Effective in the 1996 taxation year, the amount on which the credit is based was $2,353 and the credit began to be phased out at $4,103. The 1999 budget raised the net income threshold at which the credit began to be phased out to $4,778. The 2000 budget proposed to fully index the infirm dependent credit and the net income threshold at which the credit is reduced, effective January 1, 2000. Full indexation will increase this credit to 17 per cent of $2,386 and the net income threshold to $4,845 for the 2000 taxation year.

Caregiver Credit

> ***Objective:*** *This provision was introduced in the 1998 Budget to provide additional assistance to individuals providing in-home care for elderly or infirm family members.*
> *(Budget Plan, 1998.)*

The 1998 budget introduced a caregiver tax credit of up to 17 per cent of $2,353 for individuals residing with, and providing in-home care for, an elderly parent or grandparent or an infirm dependent relative. The credit amount is reduced by the dependant's net income in excess of $11,500. This measure is effective for 1998 and subsequent years. The 2000 budget proposed to fully index the caregiver tax credit and the net income threshold at which the credit is reduced effective January 1, 2000. Full indexation will increase this credit to 17 per cent of $2,386 and the net income threshold to $11,661 for the 2000 taxation year.

Canada Child Tax Benefit

> ***Objective:*** *The Child Tax Benefit consolidated a number of child-related benefits to provide assistance to low- and middle-income families with children in a simpler, fairer and more responsive manner. It also recognizes the effect of children on the ability to pay tax for low- and middle-income families. The Canada Child Tax Benefit replaced the former refundable child tax credit, family allowance and non-refundable tax credit.*
> *(Budget Papers, 1992.)*

The Canada Child Tax Benefit (CCTB) was introduced in 1993 (until July 1998, it was called the Child Tax Benefit), replacing the family allowance, the dependant credit for children under 18 years of age and the refundable child tax credit. CCTB payments are made monthly and are non-taxable.

The CCTB has two components: the CCTB base benefit for low- and middle-income families and the National Child Benefit (NCB) supplement for low-income families. For the program year July 1999 to June 2000, the CCTB base benefit provides a basic amount of up to $1,020 per child, plus $75 for the third and subsequent children. It also includes a supplement of $213 for each child under age 7, the total of which is reduced by 25 per cent of child care expenses claimed. The total base benefit is reduced by 5 per cent (2.5 per cent for one-child families) of family net income over $25,921.

The NCB supplement provides maximum benefits of $785 for the first child, $585 for the second child and $510 for each subsequent child. The NCB supplement is reduced by 11.5 per cent for a one-child family, 20.1 per cent for a two-child family and 27.5 per cent for larger families with incomes over $20,921. The NCB supplement is completely eliminated at family incomes of approximately $27,750.

The CCTB was changed in the 1997, 1998 and 1999 budgets as follows:

- In July 1997, the Working Income Supplement (WIS) was enriched and restructured. The maximum benefit under the WIS increased from $500 per family to $605 for the first child, $405 for the second child and $330 for each subsequent child.
- In July 1998, the NCB supplement replaced the WIS. The maximum NCB supplement was fixed at $605 for the first child, $405 for the second child and $330 for each subsequent child.
- In July 1999, the NCB supplement maximum was increased by $180 to $785 for the first child, $585 for the second child and $510 for each subsequent child. Also, the income threshold at which the NCB supplement was fully phased out was increased to $27,750 from $25,921.
- The 1999 budget also provided for an increase in the NCB supplement for July 2000. The NCB supplement was scheduled to increase by $170 per child, to reach $955 for the first child, $755 for the second and $680 for each additional child. In addition, the 1999 budget provided for increases in the thresholds at which NCB supplement benefits are fully phased out and the base benefit begins to be reduced to $29,590, up from $27,750 and $25,921, respectively.

The 2000 budget proposed the following changes to both the NCB supplement and the base benefit.

- Effective January 2000, CCTB parameters will be fully indexed based on the change in the CPI over the 12-month period ending on September of the preceding year. As the CCTB program year begins in July, benefits will be adjusted in July 2000 and indexation benefits for the January to June 2000 period will be paid in the second half of the year. The higher level of benefits from July to December 2000 will be maintained until future indexation raises benefits further.

- As of July 2000,[5] the CCTB base benefit will increase by $70 per child, including indexation. The CCTB base benefit will reach $1,104 per child, and the additional benefits for the third and subsequent children will reach $77. The additional benefit for children under the age of seven will increase to $219.
- The NCB supplement will increase to $977 for the first child, $771 for the second child and $694 for each subsequent child. The NCB supplement will be reduced by 11.1 per cent for a one-child family, 19.9 per cent for a two-child family and 27.8 per cent for larger families with incomes over $21,214.
- The income thresholds at which the CCTB base benefit begins to be reduced and the NCB supplement is fully phased out will be set equal to the second tax bracket threshold. For July 2000, this income threshold will reach $30,004.

The 2000 budget also proposed to increase CCTB benefits in July 2001:

- All CCTB benefits and thresholds will increase with indexation.
- The NCB supplement will be increased by $200 per child including indexation to $1,155 for the first child, $955 for the second and $880 for the third and subsequent children.

The CCTB will provide benefits to 3.4 million families and 6.2 million children in July 2000. By the end of the Five-Year Tax Reduction Plan, the CCTB will provide benefits to 3.8 million families and 6.8 million children.

Deferral of Capital Gains Through Transfers to a Spouse, Spousal Trust or Family Trust

> ***Objective:*** *This deferral recognizes that it is not always appropriate to treat a transfer of assets between spouses as a disposition for income tax purposes, and therefore allows families flexibility in structuring their total assets. However, the tax treatment of family trusts was amended in the 1995 budget to ensure that they do not provide undue tax advantages. (Budget Speech, 1971. Budget Plan, 1995.)*

Individuals may transfer capital property to their spouses/spousal trusts at the adjusted cost base of the property rather than the fair market value. This provides a deferral of the capital gain until the subsequent disposition of the property or until the transferee spouse dies.

Property transferred to other family members or to unrelated individuals (or to trusts of which they are beneficiaries) is treated differently. The transferor is generally deemed to have disposed of the property at the time of transfer at fair market value and must include any resulting capital gain in income at that time.

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5 The benefit increases for the CCTB base benefit and the NCB supplement for July 2000 include compensation amounts to cover the indexation for the period from January to June 2000. The compensation amounts are: $14 for the base benefit, $11 for the NCB supplement for the first child, $8 for the NCB supplement for the second child and $7 for the third and subsequent children.

In the case of property transferred to a trust (other than a spousal trust), capital gains are generally considered to be realized at the time of the transfer on the basis of the fair market value of the property at that time. In addition, trust assets are generally subject to a deemed realization every 21 years at the fair market value of the assets.

No data are available.

Farming and Fishing

$500,000 Lifetime Capital Gains Exemption for Farm Property

> ***Objective:*** *This measure provides an incentive to invest in the development of productive farms, and allows farm owners to accumulate capital for retirement. (Budget Papers, 1985. The Lifetime Capital Gains Exemption: An Evaluation, Department of Finance, 1995.)*

A $500,000 lifetime capital gains exemption is available for gains in respect of the disposition of qualified farm property. The $500,000 limit is reduced to the extent that the basic $100,000 lifetime capital gains exemption (where applicable) and the $500,000 lifetime capital gains exemption on small business shares have been used. Further, it can be applied only to the extent that the gains exceed cumulative net investment losses incurred after 1987.

Net Income Stabilization Account

> ***Objective:*** *The Net Income Stabilization Account program provides an income averaging mechanism for farmers, and reduces the need for other forms of government assistance to the agriculture industry. The tax-deferral component of the program is an integral aspect of this initiative.*
> *(Federal-Provincial Agreement Establishing the Net Income Stabilization Account, 1991.)*

Farmers may deposit a percentage of a given year's eligible net sales, up to a limit, to their Net Income Stabilization Account (NISA). No tax deduction is given in respect of these deposits. Some of the deposits are matchable by the federal and provincial governments. Governments also pay a 3-per-cent interest bonus annually on the farmer's deposits, which remain in the account. Governments' contributions and interest accrued in the account are not taxable until withdrawn. All withdrawals from the NISA are taxable except for the contributor's original deposits, which were made with after-tax dollars. Withdrawal entitlements from the NISA are triggered if the current year gross margin (net sales less eligible expenses) is less than the average gross margin from previous years (up to five), or if net income is below $10,000 (or $20,000 for family net income if the family held only one account).

The federal tax expenditure is a function of three components: the deferral of tax on government contributions to the account; the deferral of tax on the investment income accrued in the account; and the income inclusion of these amounts when withdrawn from the account. The deferrals have the effect of increasing tax expenditures, while withdrawals have the opposite effect. The estimates provided in the table are made on a current cash-flow basis – that is, they measure the impact on revenues in each of the years under consideration.

Deferral of Income From Destruction of Livestock

> ***Objective:*** *This deferral was introduced to allow farmers operating on a cash basis adequate time to replace their herds, destroyed under statutory authority, without imposing a tax burden in the year of livestock destruction. (Budget Papers, 1976.)*

If the taxpayer elects, when there has been a statutory forced destruction of livestock, the income received from the forced destruction can be deemed to be income in the following year. The deferral is also available when the herd has been reduced by at least 15 per cent in a drought year. This provision allows for a deferral of income to the following year when the livestock is replaced. Under the benchmark tax system, income is taxable when it accrues.

The estimates are based on data provided by Agriculture and Agri-Food Canada.

Deferral of Income From Grain Sold Through Cash Purchase Tickets

> ***Objective:*** *By permitting the deferral of the reporting of income on grain sales, this measure facilitates the orderly delivery of grain to elevators, ensuring that Canada meets its grain export commitments. (Budget Papers, 1974.)*

Farmers may make deliveries of grain before the year-end and be paid with a ticket that may be cashed only in the following year. The payment for deliveries of grain is included in income only when the ticket is cashed, thereby providing a deferral of taxes. Under the benchmark tax system, income would be taxed on an accrual basis.

The estimates are based on data provided by the Canadian Wheat Board. Since tax expenditures are estimated on a cash-flow basis, an increase in the balance of uncashed grain tickets represents additional income that is being deferred and results in a positive estimate of the tax expenditure. A decrease in the balance of uncashed grain tickets indicates that less income is being deferred and results in a negative tax expenditure.

Deferral Through 10-Year Capital Gain Reserve

> ***Objective:*** *This provision, while limiting tax deferral opportunities, recognizes that where proceeds are receivable over time, fully taxing gains in the year of sale could result in significant liquidity problems for taxpayers. The longer period of deferral for gains on the sale of farm property was introduced to ease the transfer of these assets between family members. (Explanatory Notes for Act to Amend the Income Tax Act, December 1982.)*

If proceeds from a sale of a farm property to a child, grandchild or great-grandchild are not all receivable in the year of sale, realization of a portion of the capital gain may be deferred until the year in which the proceeds become receivable. However, a minimum of 10 per cent of the gain must be brought into income each year, creating a maximum 10-year reserve period. For most other assets, the maximum reserve period is five years.

Deferral of Capital Gains Through Intergenerational Rollovers of Family Farms

Objective: *This measure allows for continuity in the management of family farms in Canada by permitting property used principally in a family farming business to pass from generation to generation on a tax-deferred basis.*
(Budget Supplementary Information, 1973.)

Sales or gifts of assets to children, grandchildren or great-grandchildren typically give rise to taxable capital gains to the extent that the fair market value exceeds the adjusted cost base of the property. However, capital gains on intergenerational transfers of farm property are deferred in certain circumstances until the property is disposed of outside the immediate family.

No data are available.

Exemption From Making Quarterly Tax Instalments

Objective: *This measure ensures consistency in the tax treatment of farmers reporting income on a cash-flow basis. (Budget Speech, 1943.)*

Taxpayers earning business income must normally pay quarterly income tax instalments. However, individuals engaged in farming and fishing pay two-thirds of their estimated tax payable at the end of the taxation year and the remainder on or before April 30 of the following year.

No data are available.

Cash Basis Accounting

Objective: *This treatment recognizes that requiring all farmers and fishers to adopt the accrual method of income reporting could result in accounting and liquidity problems. (Report of the Royal Commission on Taxation, 1966, vol. 4., Proposals for Tax Reform, 1969.)*

Individuals engaged in farming and fishing may elect to include revenues when received, rather than when earned, and deduct expenses when paid rather than when the related revenue is reported. This treatment allows a deferral of income inclusion and a current deduction for prepaid expenses. Under the benchmark tax structure, income is taxable when it accrues, and expenses are deductible in the period to which they relate.

No data are available.

Flexibility in Inventory Accounting

> ***Objective:*** *This measure ensures that farmers operating on a cash basis are able to avoid creating losses that would be subject to the time limitation if carried forward. (Budget Supplementary Information, 1973.)*

Farmers using the cash basis method of accounting are allowed to depart from it with regard to their inventory. A discretionary amount, not exceeding the fair market value of farm inventory on hand at year-end, may be added back to income each year. This amount must then be deducted from income in the following year. The effect of this provision is to allow farmers to avoid creating losses, which would be subject to the time limitation if carried forward. The value of the tax expenditure is thus the amount of tax relief associated with the losses that would otherwise have been subject to the time limitations.

No data are available.

Federal-Provincial Financing Arrangements

Quebec Abatement

> ***Objective:*** *This provision reflects the election by the Province of Quebec to receive part of the federal program contribution in the form of a tax abatement. (Federal-Provincial Fiscal Revision Act, 1964. Federal-Provincial Fiscal Arrangements Act, Part VI.)*

Under the contracting-out arrangements that were offered to provinces in the mid-1960s for certain federal transfer programs, provinces could elect to receive part of the federal contribution in the form of a tax abatement. Quebec was the only province to elect this arrangement at the time and this has resulted in a 16.5-percentage-point abatement of federal tax for Quebec residents. The 16.5 percentage points are the total of both the 13.5 percentage points of personal income tax abated as an Alternative Payment for Standing Programs and 3 personal income tax percentage points abated for the discontinued Youth Allowance Program.

Transfers of Income Tax Room to Provinces

> ***Objective:*** *This provision reflects transfers in 1967 and 1977 by the federal government of tax points to all provinces in place of certain direct cash transfers. The tax point transfer assists provinces in providing services in the areas of post-secondary education, hospital insurance and medicare programs.*
> *(Federal-Provincial Fiscal Arrangements Act, Part V.)*

In 1967, the federal government transferred four tax points of personal income tax collections and one percentage point of the corporate tax to all provinces in place of certain direct cash transfers under the cost-shared program for post-secondary education. With the 1972 income tax reform, the transferred tax points were equivalent to 4.357 tax points of personal income tax. In 1977, an additional 9.413 percentage points of personal income tax were provided to the provinces in respect of post-secondary education, hospital insurance and medicare programs.

General Business and Investment

$100,000 Lifetime Capital Gains Exemption

> ***Objective:*** *This exemption was introduced to encourage risk taking and investment. The exemption was eliminated for gains accrued after February 22, 1994, to make the taxation of capital gains fairer, simpler and more sustainable.*
> *(Budget Papers, 1985. Tax Reform 1987: The White Paper, 1987. Tax Measures: Supplementary Information, 1994.)*

The 1994 budget eliminated the $100,000 lifetime capital gains exemption (LCGE) for gains accrued after February 22, 1994. Accrued gains prior to that date were grandfathered. Individuals who had not disposed of their assets on that date were allowed to elect to claim the $100,000 LCGE on their 1994 tax return for gains accrued up to February 22, 1994. They were deemed to have disposed of their assets for an amount not exceeding their fair market value on that date.

The LCGE allowed individuals to exempt up to $100,000 in realized capital gains over their lifetime. The exemption was available only to the extent that the gains exceeded cumulative net investment losses incurred after 1987. The costs of tax expenditures associated with capital gains realized on exempt qualified farm property and exempt qualified small business shares are listed separately, even though some of these gains would qualify for the $100,000 LCGE.

The 1992 budget had already eliminated the exemption for real estate gains accruing after February 1992 on property not used in an active business.

Partial Inclusion of Capital Gains

> ***Objective:*** *The reduced rate of inclusion for capital gains provides incentives to Canadians to save and invest, and to ensure that Canada's treatment of capital gains is broadly comparable to that of other countries.*
> *(Proposals for Tax Reform, 1969. Tax Reform 1987: The White Paper, 1987.)*

Only a portion of net realized capital gains are included in income. The amount of the tax expenditure is the additional tax that would have been collected had the full amount of the capital gains been included in income. The 2000 budget proposed to reduce the capital gains inclusion rate from three-quarters to two-thirds effective February 28, 2000.

Deduction of Limited Partnership Losses

> ***Objective:*** *This provision allows for the deductibility of business losses for limited partnerships in a manner consistent with other forms of business organizations.*
> *(Budget Papers, 1986.)*

A limited partner is able to deduct losses against other income up to the amount of investment at risk whereas a shareholder is normally not permitted to deduct corporate losses against personal income. Unused losses may be carried back three years or forward seven years. Limited partnership losses arise from a range of investments, from real

estate investments to certified film productions. It is estimated that 15 per cent of this tax expenditure for years before 1995 is attributable to capital cost allowance claimed on Canadian films.

Investment Tax Credits

> ***Objective***: *These incentives were introduced to stimulate investments in productive facilities, and to generate growth and employment in specified regions. (Budget Supplementary Information, 1975. Budget Papers, 1977 and 1978.)*

Tax credits are available for investments in scientific research and experimental development, exploration activities and certain regions. The tax credits range from 15 per cent to 45 per cent. The estimates treat the full investment tax credit as a tax expenditure even though tax credits reduce the capital cost of assets for capital cost allowance purposes and the adjusted cost base for capital gains purposes.

Deferral Through Five-Year Capital Gain Reserve

> ***Objective:*** *This provision, while limiting the tax deferral opportunities, recognizes that where proceeds are receivable over time, fully taxing gains in the year of sale could result in significant liquidity problems for taxpayers. (Explanatory Notes for Act to Amend the Income Tax Act, December 1982.)*

If proceeds from a sale of capital property are not all receivable in the year of the sale, realization of a portion of the capital gain may be deferred until the year in which the proceeds are received. A minimum of 20 per cent of the gain must be brought into income each year, creating a maximum five-year reserve period.

Deferral Through Capital Gains Rollovers

> ***Objective:*** *Rollover provisions are provided in some situations in which it would be unfair to collect a capital gains tax even though the taxpayer has sold or otherwise disposed of an asset at a profit. (Proposals for Tax Reform, 1969.)*

In certain circumstances, taxpayers may defer the reporting of capital gains for tax purposes. General business rollover provisions may be categorized into three groups:

Involuntary dispositions

Capital gains resulting from an involuntary disposition (e.g. insurance proceeds received for an asset destroyed in a fire) may be deferred if the funds are reinvested in a replacement asset within a specified period. The capital gain is taxable upon disposition of the replacement property.

Voluntary dispositions

Capital gains resulting from the voluntary disposition of land and buildings by businesses may be deferred if replacement properties are purchased soon thereafter (e.g., a business changing location). The rollover is generally not available for properties used to generate rental income.

Transfers to a corporation for consideration including shares

Individuals may transfer an asset to a corporation controlled by them or their spouses and elect to roll over any resulting capital gain or recaptured depreciation into the corporation instead of paying tax in the year of sale.

No data are available.

Deferral Through Use of Billed-Basis Accounting by Professionals

> ***Objective:*** *This treatment recognizes the inherent difficulty in valuing unbilled time and work in progress. (Summary of 1971 Tax Reform Legislation, 1971.)*

Under accrual accounting, costs must be matched with their associated revenues. In computing their income for tax purposes, however, professionals are allowed to elect either an accrual or a billed-basis accounting method. Under the latter method, the costs of work in progress can be written off as incurred even though the associated revenues are not brought into income until the bill is paid or becomes receivable. This treatment gives rise to a deferral of tax.

No data are available.

Deduction of Accelerated Tax Depreciation

> ***Objective:*** *Accelerated rates of capital cost allowance are allowed for various types of property to encourage investment in these assets.*
> *(The Corporate Income Tax System: A Direction for Change, May 1985.)*

The depreciation allowable for tax purposes is called capital cost allowance. It may differ from true economic depreciation. A tax deferral may thus be created when the tax deductions in the early years of the life of an asset exceed the actual depreciation in the value of the asset. The difference is captured upon subsequent disposition of the asset.

$1,000 Capital Gains Exemption on Personal-Use Property

> ***Objective:*** *This exemption was introduced to minimize record keeping and simplify administration with respect to the purchase and disposal of personal-use items. (Summary of 1971 Tax Reform Legislation, 1971).*

Personal-use property is held primarily for the use and enjoyment of the owner rather than as an investment. In calculating the capital gain on personal-use property, if the proceeds of disposition are less than $1,000, no capital gain needs to be reported. If the proceeds exceed this amount, the adjusted cost base (ACB) will be deemed to be a minimum of $1,000, thus reducing the capital gain in situations where the true ACB is less than $1,000.

The 2000 budget proposed to amend the rules so that the $1,000 deemed adjusted cost base and deemed proceeds of disposition for personal-use property will not apply if the property is acquired after February 27, 2000, as part of an arrangement in which the property is donated as a charitable gift.

No data are available.

$200 Capital Gains Exemption on Foreign Exchange Transactions

> ***Objective:*** *This exemption was introduced to minimize record keeping and simplify administration with respect to modest foreign exchange transactions. This provision is analogous to the exemption on personal-use property. (Section 39(2), Income Tax Act.)*

The first $200 of net capital gains on foreign exchange transactions is exempt from tax.

No data are available.

Taxation of Capital Gains Upon Realization

> ***Objective:*** *This treatment recognizes that, in many cases, it is difficult to estimate with accuracy the value of unsold assets, and that taxing the accrued gains on assets that have not been sold would be administratively complex and could create significant liquidity problems for taxpayers.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

Capital gains are taxed upon the disposition of property and not on an accrual basis. This treatment results in a tax deferral. Under the benchmark tax system, capital gains would be fully included in income as they accrue.

No data are available.

Health

Non-Taxation of Business-Paid Health and Dental Benefits

> ***Objective:*** *This provision improves access to supplementary health and dental benefits. (Budget Plan, 1998.)*

Employer-paid benefits for private health and dental plans are not taxable. The 1998 budget provided for the deduction from business income of premiums paid for the coverage of self-employed persons, subject to certain restrictions. The estimates are based on data from Statistics Canada and from an annual survey, *Health Insurance Benefits in Canada*, conducted by the Canadian Life and Health Insurance Association.

Disability Tax Credit

> ***Objective:*** *This credit improves tax fairness by recognizing the effect of a severe and prolonged disability on an individual's ability to pay tax. (Budget Plan, 1997.)*

Canadians who are markedly restricted by disabilities in the carrying on of the basic activities of daily living are entitled to a tax credit. For 1999, the credit was 17 per cent of $4,233. Any unused amount of the credit may be transferred to a supporting person.

The 2000 budget proposed to fully index this tax credit to the rate of inflation, effective January 1, 2000, which will raise the credit amount to $4,293 for the 2000 taxation year. The budget proposed to broaden eligibility for the credit to include individuals with severe and prolonged disabilities requiring extensive therapy essential to sustain their vital functions. In addition, the transfer rules for the credit will be broadened to allow

the transfer of unused amounts to an expanded list of supporting relatives, making it consistent with the medical expense tax credit rules (such as a brother, sister, aunt, uncle, niece or nephew).

The 2000 budget also proposed a supplement to the disability tax credit for children under 18 years of age of up to 17 per cent of $2,941 to better recognize caregivers of children with severe disabilities. The $2,941 supplement amount is reduced by the amount of child care expenses and attendant care expenses claimed, in respect of the child, exceeding $2,000. The supplement is reduced to zero when child care and attendant care expenses reach $4,941.

Medical Expense Tax Credit

Objective: *This credit recognizes the effect of above-average medical expenses on the ability of an individual to pay tax. (Budget Speech, 1942. Budget Plan, 1997.)*

Taxpayers are entitled to a 17-per-cent credit for eligible medical expenses incurred by the taxpayer, the taxpayer's spouse or by dependants. The credit is available in respect of expenses that exceed the lesser of $1,614 or 3 per cent of net income. The 1998 budget allowed supporting persons to claim the medical expense tax credit for training courses related to the care of dependent relatives with physical or mental infirmities. The 1999 budget extended the medical expense tax credit to include certain costs of group homes for persons with disabilities, certain therapies for persons with disabilities and tutoring and talking books for persons with learning disabilities. The 2000 budget proposed to fully index the personal income tax system, including the $1,614 threshold which will increase to $1,637 for the 2000 taxation year. The 2000 budget also proposed to expand the list of expenses eligible for the medical expense tax credit to include the incremental cost of modifications made to new homes to assist individuals with severe mobility impairments.

Medical Expense Supplement for Earners

Objective: *This measure improves incentives for disabled Canadians to participate in the labour force by providing an alternative to disability-related supports under provincial social assistance arrangements. (Budget Plan, 1997.)*

The 1997 budget created a refundable medical expense tax credit for low-income working Canadians with high medical expenses.

The refundable credit supplements the assistance that is provided through the existing medical expense tax credit. From 1997 to 1999, the maximum refundable credit was the lesser of $500 and 25 per cent of eligible medical expenses. It was available to those individuals earning over $2,500, and was reduced by 5 per cent of net family income in excess of $16,069 in 1997 and 1998, and in excess of $17,419 in 1999. The 2000 budget proposed to fully index the $500 supplement, the minimum earnings threshold and the family net income threshold by the rate of inflation, effective January 1, 2000. Full indexation will increase the supplement to $507, the minimum earnings threshold to $2,535, and the family net income threshold to $17,664 for the 2000 taxation year.

Income Maintenance and Retirement

The non-taxation of income-tested programs such as the Guaranteed Income Supplement and provincial social assistance presents conceptual difficulties. The problems arise because, in many respects, these programs operate like an income tax in that eligibility for benefits is phased out after a certain income level. In this regard, excluding such benefits from income tax might not be considered a tax expenditure since they are subject to their own "tax." On the other hand, a broadly based benchmark tax system would include such amounts in income. Given the comprehensive approach taken in this document, these items are considered to be tax expenditures.

Non-Taxation of Guaranteed Income Supplement and Spouse's Allowance Benefits

Objective: *This treatment recognizes that these income-tested payments provide a basic level of support to elderly Canadians with little income other than the Old Age Security pension. (Budget Speech, 1971.)*

The Guaranteed Income Supplement (GIS) is an income-tested benefit payable to Old Age Security (OAS) pensioners. Spouses of OAS recipients (or widows/widowers) aged 60 to 64 may be eligible for the spouse's allowance (SPA). Benefits under both the GIS and SPA programs are non-taxable. Although GIS and SPA benefits must be included in income, an offsetting deduction from net income is provided. This approach effectively exempts such payments from taxation while continuing to have them affect income-tested credits.

The estimates are based on data from Human Resources Development Canada and the personal income tax simulation model developed by the Department of Finance Canada from tax data.

Non-Taxation of Social Assistance Benefits

Objective: *This treatment recognizes the nature of social assistance as a payment of last resort. (Budget Papers, 1981.)*

Social assistance benefits must be included in income. However, an offsetting deduction from net income is provided. This approach effectively exempts such benefits from taxation while continuing to have them affect income-tested credits.

The estimates are based on data from Human Resources Development Canada and the personal income tax model developed by the Department of Finance Canada from tax data.

Non-Taxation of Workers' Compensation Benefits

> ***Objective***: *Workers' compensation benefits have been non-taxable since the first Workers' Compensation Boards were established in 1915. Prior to 1982, workers' compensation payments were excluded from income. The 1981 budget included these payments in income and provided a matching deduction. (Budget Papers, 1981.)*

Workers' compensation benefits must be included in income. However, an offsetting deduction from net income is provided. This approach effectively exempts such benefits from taxation while continuing to have them affect income-tested credits.

Non-Taxation of Certain Amounts Received as Damages in Respect of Personal Injury or Death

> ***Objective:*** *By exempting from tax funds and annuities resulting from personal injury, this provision recognizes that amounts received as personal injury damages represent, to a large extent, compensation for a capital loss suffered by the injured taxpayer. (Budget Supplementary Information, 1972.)*

Amounts received in respect of damages for personal injury or death and awards paid pursuant to the authority of criminal injury compensation laws are not taxable. In addition, investment income earned on personal injury awards is excluded from income until the end of the year in which the person reaches the age of 21.

The values reported in the tables understate the tax expenditure since they are based on awards paid by provinces' Criminal Injuries Compensation Boards only. No data were available for compensation awards paid by other sources, or regarding the investment income earned on awards by individuals under age 22.

Non-Taxation of Veterans' Allowances, Civilian War Pensions and Allowances, and Other Service Pensions (Including Those From Allied Countries)

> ***Objective:*** *This treatment recognizes that these benefits provide a basic level of support to veterans of Canada's military engagements and their families. (Budget Speech, 1942.)*

These amounts are not included in income for tax purposes.

The estimates are based on Public Accounts data.

Non-Taxation of Veterans' Disability Pensions and Support for Dependants

> ***Objective:*** *This treatment recognizes that these benefits provide a basic level of support to veterans of Canada's military engagements and their families. (Budget Speech, 1942.)*

These amounts are not included in income for tax purposes.

The estimates for this item are based on Public Accounts data.

Treatment of Alimony and Maintenance Payments

> ***Objective:*** *The tax treatment of child support was changed following the 1996 Budget. The new tax rules work in tandem with the Federal Child Support Guidelines to ensure that children receive the financial support they deserve. As of May 1, 1997, child support paid under orders or agreements made on or after that date is no longer taxable to the recipient nor deductible by the payor. (Budget Plan, 1996.)*

Payments by a taxpayer to a divorced or separated spouse are deductible to the payer and taxable in the hands of the recipient for agreements or awards made prior to May 1, 1997.

This treatment represented a tax expenditure because it departed from the benchmark system established for the purposes of this report. Under this benchmark tax system, deductions are permitted only for expenses incurred in order to earn income, and amounts received from other individuals are not included in the income of the recipient.

As of May 1, 1997, child support paid pursuant to a written agreement or court order made on or after that day is not deductible to the payer nor included in the income of the recipient. Child support paid pursuant to a court order or written agreement made before that date continues to be deductible to the payer and included in the income of the recipient, unless the agreement is varied. The tax changes do not apply to spousal support. Spousal support payments remain deductible by the payer and are included in the income of the recipient.

The estimates for this item are computed as the value of the deduction to the payer, less the tax collected from the recipient.

Age Credit

> ***Objective:*** *This provision was introduced to reduce the tax burden borne by elderly Canadians. (Budget Highlights, 1972.)*

Individual taxpayers aged 65 and over are entitled to claim a tax credit of up to 17 per cent of $3,482. Unused portions may be transferred to a spouse. The age credit became subject to an income test in 1994, which was phased-in over two years. For 1995 and future years, the age amount was reduced by 15 per cent of net income in excess of $25,921 (for 1994, the reduction was one-half of this amount). The 2000 budget proposed to fully index by the rate of inflation both the age credit amount and the net income threshold at which it is reduced, effective January 1, 2000. Full indexation will increase the age credit amount to $3,531 and the net income threshold at which the credit amount is reduced to $26,284 for the 2000 taxation year.

Pension Income Credit

> ***Objective:*** *This provision was introduced to provide additional protection against inflation for the retirement income of elderly Canadians.*
> *(Budget Speech, November 1974.)*

A 17-per-cent tax credit is available on up to $1,000 of certain pension income. The unused portion of the credit may be transferred to a spouse.

Saskatchewan Pension Plan

> ***Objective:*** *This measure was introduced to ensure consistency in the tax treatment of Canadians saving for their retirement, whether they save through a private or a provincially sponsored registered plan. (Budget Papers, 1987.)*

Contributions to the Saskatchewan Pension Plan are deductible up to the lesser of $600 or the amount of unused registered retirement savings plan room in a particular year.

Registered Retirement Savings Plans/Registered Pension Plans

> ***Objective:*** *These measures were introduced to encourage Canadians to save throughout their working lives in order to avoid a serious disruption of their living standards upon retirement. (Pension Reform: Improvements in Tax Assistance for Retirement Saving, Department of Finance, 1989.)*

The federal revenue forgone due to the provisions pertaining to registered retirement savings plans (RRSPs), registered pension plans (RPPs) and deferred profit-sharing plans (DPSPs) is a function of three components: the deductibility of contributions to such plans; the non-taxation of investment income accrued within such plans; and the income inclusion of RPP/RRSP withdrawals, which reduces the cost resulting from the previous two components. Individuals benefit from a deferral of tax on amounts contributed and on investment income. Also, there is an absolute tax saving to the extent that the tax rate on withdrawals is below that faced at the time of contributions. That is, many contributors are in a higher tax bracket during their working lives than when they are retired.

The estimates provided in the table are made on a current cash-flow basis – that is, they measure the impact of this tax measure on revenues in the years under consideration. The Auditor General has recommended that the estimates for RPPs and RRSPs be provided on a present-value basis as well as on the current cash-flow basis. Work is proceeding on developing such estimates, although they are not yet ready to be included in this year's report.

In 1991, a new system of comprehensive limits on tax-assisted retirement saving took effect. Under this system, saving in RRSPs, RPPs and DPSPs is governed by a comprehensive limit of 18 per cent of earnings up to a dollar amount. In more detail, the limits are as follows.

- For defined benefit pension plans, the limits are the same as in 1990 – i.e., no fixed limits on employee contributions while employer contributions are restricted to the amounts necessary to fully fund the promised benefits. Annual pension benefits under these pension plans are limited to the lesser of $1,722 and 2 per cent of earnings for each year of pensionable service.
- For RRSPs, contributions are limited to 18 per cent of earned income for the preceding taxation year up to a dollar maximum ($14,500 for 1995 and $13,500 from 1996 to 2003), minus a pension adjustment (PA). The PA is based on RPP or DPSP benefits earned by plan members in the previous taxation year. For a money purchase RPP or a DPSP, the PA is simply the total contribution made by or on behalf of a plan member in the year. For a defined benefit RPP, the PA is a measure of the benefits earned in the year, calculated according to a prescribed formula.

In 1992, the federal government introduced the Home Buyers' Plan (HBP) as a temporary measure. It allowed individuals to withdraw up to $20,000 from their RRSPs on a tax-free basis to purchase a home. Amounts withdrawn under the HBP are to be repaid to the individual's RRSP on an interest-free basis over a period of 15 years. Amounts that are not repaid are included in the individual's income for tax purposes. In 1994, this measure was made permanent, but restricted to first-time home buyers only. The 1998 budget allowed persons eligible for the disability tax credit to participate in the HBP more than once in the individual's lifetime. The funds must be used to purchase a home that is more accessible for, or better suited for, the care of the individual.

The 1998 budget also allowed individuals to make tax-free RRSP withdrawals for lifelong learning, subject to certain restrictions. Individuals have to repay these amounts over a fixed period of time. In many ways, this program parallels the HBP.

The tax expenditure costs of both the HBP and the lifelong learning program are reflected in the RRSP tax expenditure estimates through the amount of tax forgone on contributions and investment income.

It should be noted that the RRSP/RPP estimates do not reflect a mature system because contributions currently exceed withdrawals. Assuming that the same tax rate applies to contributions and withdrawals, if contributions equalled withdrawals, only the non-taxation of investment income would contribute to the net cost of the tax expenditure.

As time goes by and more retired individuals have had the opportunity to contribute to RRSPs throughout their lifetime, the gap between contributions and withdrawals will shrink and possibly even become negative. The upward bias in the current cash-flow estimates can therefore be expected to decline.

The estimates may not reflect the benefit to a particular individual in any given year because the individual is typically either a contributor or withdrawer at a point in time but not both. In order to estimate the benefit to a particular individual, one could calculate the difference in disposable income between a situation in which an individual invests in an RRSP/RPP and one in which the individual invests in a non-sheltered savings instrument.

Data used to estimate the value of these measures were taken from the personal income tax model and from Statistics Canada publications *Trusteed Pension Funds* (Cat. 74-201) and *Pension Plans in Canada* (Cat. 74-401).

Deferred Profit-Sharing Plans

Objective: *This treatment was introduced to allow for additional retirement savings, and to foster co-operation between employers and their workers by encouraging employees to participate in their employer's business. (Budget Speech, 1960.)*

Employers may make tax-deductible contributions to a deferred profit-sharing plan on behalf of their employees. These amounts are taxable in the hands of the employees when withdrawals are made from the plan. The employer's contribution cannot exceed one-half of the money purchase registered pension plan (RPP) dollar limit for the year ($7,750 in 1995, $6,750 from 1996 to 2002) or 18 per cent of the employee's earnings. The amount is included in the pension adjustment (PA) for the taxpayer. The taxpayer's total PA

(for both RPP and DPSP contributions) cannot exceed the money purchase RPP dollar limit for the year ($15,500 for 1995, $13,500 for 1996 to 2002).

No data are available.

Non-Taxation of RCMP Pensions/Compensation in Respect of Injury, Disability or Death

> ***Objective:*** *This treatment recognizes that these benefits represent, to a large extent, compensation to Canada's national police force and their families for a capital loss suffered by members of this police force injured in the course of their duties. (Section 81(1)(l), Income Tax Act.)*

Pension payments and other compensation received in respect of an injury, disability or death associated with service in the Royal Canadian Mounted Police are non-taxable.

No data are available.

Non-Taxation of up to $10,000 of Death Benefits

> ***Objective:*** *This provision was introduced to alleviate the hardship faced by dependants upon the death of a supporting individual. (Budget Speech, 1959.)*

Up to $10,000 of death benefits paid by an employer to the spouse of a deceased employee is non-taxable.

No data are available.

Non-Taxation of Investment Income on Life Insurance Policies

> ***Objective:*** *For administrative convenience, insurance companies rather than policy holders are taxed on investment income earned on certain life insurance policies.*

The investment income earned on some life insurance policies is not taxed as income to the policyholder. Instead, for reasons of administrative convenience, insurance companies are subject to tax on such earnings.

Small Business

$500,000 Lifetime Capital Gains Exemption for Small Business Shares

> ***Objective:*** *This measure was introduced to bolster risk taking and investment in small businesses, allow small business owners to accumulate funds for retirement and facilitate intergenerational transfers. (Budget Papers, 1985. The Lifetime Capital Gains Exemption: An Evaluation, Department of Finance, 1995.)*

A $500,000 lifetime capital gains exemption is available for gains in respect of the disposition of qualified small business shares. The $500,000 limit is available only to the extent that the basic $100,000 lifetime capital gains exemption (where applicable) and the $500,000 lifetime capital gains exemption on qualified farm property have not been

used, and to the extent that the gains exceed cumulative net investment losses incurred after 1987.

Deduction of Allowable Business Investment Losses

> ***Objective:*** *This measure recognizes that small businesses often have difficulty obtaining adequate financing, and provides special assistance for risky investments in such businesses. (Budget Papers, 1985.)*

Under the benchmark system, capital losses arising from the disposition of shares and debts are generally deductible only against capital gains. However, a portion of capital losses in respect of shares or debts of a small business corporation (allowable business investment losses) may be used to offset other income. The 2000 budget proposed that this proportion be reduced from three-quarters to two-thirds, effective February 28, 2000, as a consequence of the reduction in the capital gains inclusion rate. Unused allowable business investment losses may be carried back three years and forward seven years. After seven years, the loss reverts to an ordinary capital loss and may be carried forward indefinitely.

The estimated tax expenditure is the amount of tax relief provided by allowing these losses to be deducted from other income in the year. The tax expenditure is overestimated since it does not reflect the future reduction in tax revenues that would occur if those losses were instead deducted from future capital gains.

Labour-Sponsored Venture Capital Corporations Credit

> ***Objective:*** *This measure was introduced to foster entrepreneurship by encouraging investment by individuals in labour-sponsored venture capital organizations, set up to maintain or create jobs and stimulate the economy. (Budget Papers, 1985.)*

A tax credit is provided to individuals for the acquisition of shares of labour-sponsored venture capital corporations. For shares acquired before March 6, 1996, the rate of the federal credit was 20 per cent to a maximum credit of $1,000. For shares acquired after March 5, 1996 for the 1996 taxation year and for the 1997 taxation year, the rate of the federal tax credit was 15 per cent, to a maximum credit of $525. For 1998 and subsequent years, the rate of the federal tax credit is 15 per cent, to a maximum credit of $750.

Deferral Through 10-Year Capital Gain Reserve

> ***Objective:*** *This provision, while limiting the tax deferral opportunities, recognizes that where proceeds are receivable over time, fully taxing gains in the year of sale could result in significant liquidity problems for taxpayers. The longer period of deferral for gains on the sale of small business shares was introduced to ease the transfer of these assets between family members.*
> *(Explanatory Notes for Act to Amend the Income Tax Act, December 1982.)*

If proceeds from the sale of small business shares to children, grandchildren or great-grandchildren are not all receivable in the year of sale, recognition of a portion of the capital gain realized may be deferred until the year in which the proceeds become receivable. However, a minimum of 10 per cent of the gain must be brought into income

each year creating a maximum 10-year reserve period. This contrasts with the treatment of most other property, where the maximum reserve period is five years.

Rollovers of Investments in Small Businesses

> ***Objective:*** *To improve access to capital for small business corporations, the 2000 Budget proposed to permit individuals a rollover of capital gains on the disposition of small business investments where the proceeds of disposition are used to make other small business investments. (Budget Plan 2000.)*

The 2000 budget proposed that individuals be permitted to defer the tax on a capital gain arising from the disposition of a qualified small business investment, to the extent the proceeds are reinvested in another qualified small business. An eligible small business investment consists of shares issued from treasury in an active Canadian-controlled private corporation with assets not exceeding $2.5 million. The reinvestment must take place within a specified period. The deferral applies to the capital gain on investments of up to $500,000. The proposal applies to dispositions and reinvestments of qualified small business investments on or after February 28, 2000.

No data are available.

Other Items

Non-Taxation of Capital Gains on Principal Residences

> ***Objective:*** *This exemption recognizes that principal homes are generally purchased to provide basic shelter and not as an investment. The exemption also increases flexibility in the housing market by allowing families to more easily move from one principal residence to another in response to their changing circumstances.*
> *(Summary of 1971 Tax Reform Legislation, 1971. 1981 Budget Information Kit.)*

Capital gains realized on the disposition of a taxpayer's principal residence are non-taxable. The capital gains were determined using Multiple Listing Service housing prices, adjusted to include expenditures on capital repairs and major additions and renovations, obtained from Statistics Canada's Consumer Expenditure Survey. The holding period for principal residences was derived from 1981 census data.

Estimates for this item are provided for partial and full inclusion rates for capital gains.

Non-Taxation of Income From the Office of the Governor General

> ***Objective:*** *This exemption ensures that the income from the Office of the Governor General, who is a direct representative of the Crown, is not subject to tax.*
> *(The exemption was introduced in the 1917 Income War Tax Act.)*

This income is exempt from personal income taxation.

The estimates are based on Public Account data.

Assistance for Prospectors and Grubstakers

> ***Objective:*** *This treatment was introduced to encourage the development of Canada's natural resources by allowing prospectors and grubstakers to transfer their property claims or interests to a corporation in exchange for shares in that corporation on a tax-deferred basis. (Budget Supplementary Information, May 1974.)*

Where a prospector or grubstaker disposes of mining property to a corporation in exchange for shares in that corporation, the tax liability is deferred until the subsequent disposition of the shares. At that time, only a portion of the amount for which the mining property was transferred to the corporation need be included in income. The 2000 budget proposed that the taxable portion of the amount be reduced from three-quarters to two-thirds, effective February 28, 2000.

Charitable Donations Credit

> ***Objective:*** *This incentive is designed to support the important work of the charitable sector in meeting the needs of Canadians. (Report of the Royal Commission on Taxation, 1966, vol. 3. Budget Plan, 1996. Budget Plan, 1997.)*

A tax credit is available for charitable donations. The credit is 17 per cent on the first $200 of total donations and 29 per cent on donations in excess of $200. Prior to 1997, tax credits arising from gifts to the Crown could be used to reduce taxes on up to 100 per cent of income. Donations to non-Crown charities were eligible for this credit up to 20 per cent of net income in 1995 and up to 50 per cent of net income in 1996. The 1997 budget set the income limit for donations to 75 per cent for donations to all charities. The limit is increased by 25 per cent of the amount of taxable capital gains arising from the donations of appreciated capital property and 25 per cent of any capital cost allowance (CCA) recapture arising from the donation of depreciable capital property.

Provision was made in 1996 and maintained in the 1997 measures to ensure that no short-term tax liability would arise from the realization of capital gains on donations of appreciated assets. This treatment was extended in the 1997 budget to any CCA recapture arising from the donation of depreciable capital property. Donations in excess of the limit may be carried forward for up to five years. The percentage of income restriction does not apply to certain gifts of cultural property nor, beginning in 1995, to donations of ecologically sensitive lands.

In the 1997 tax year, the Canada Customs and Revenue Agency (then Revenue Canada) ceased to differentiate gifts to the Crown from donations to other charities since they are now treated equivalently in the Income Tax Act. For that reason, gifts to the Crown are no longer identified separately.

Reduced Inclusion Rate for Capital Gains Arising From Donations of Ecologically Sensitive Land

> ***Objective:*** This measure was introduced to enhance the incentives for the protection of Canada's ecologically sensitive land, including areas containing habitat for species at risk. *(Budget Plan, 2000.)*

The 2000 budget proposed to reduce by one-half the income inclusion in respect of capital gains arising from gifts of ecologically sensitive land. This reduces the capital gains income inclusion rate from two-thirds to one-third, effective February 28, 2000.

No data are available.

Reduced Inclusion Rate for Capital Gains Arising From Certain Charitable Donations

> ***Objective:*** *This measure was introduced to facilitate the transfer of certain publicly traded securities to charities to help them respond to the needs of Canadians, and to provide a level of tax assistance for donations of eligible appreciated capital property that is comparable to that in the United States. (Budget Plan, 1997.)*

The 1997 budget reduced by half the inclusion rate on capital gains arising from certain donations by individuals or corporations to charities (other than private charitable foundations) where the donation is made between February 18, 1997 and the end of the year 2001. The 2000 budget proposed to reduce the capital gains inclusion rate from three-quarters to two-thirds, effective February 28, 2000. Consequently, the reduced inclusion rate for capital gains arising from certain donations is $37^1/_2$ per cent between February 18, 1997 and February 27, 2000 and $33^1/_3$ per cent beginning February 28, 2000. Eligible securities qualifying for this treatment are those for which a current value can readily be obtained, generally securities that are traded publicly on a prescribed stock exchange. The 2000 budget proposed to provide parallel treatment of gifts of shares acquired through employee stock option plans.

Political Contribution Tax Credit

> ***Objective:*** *This provision is intended to ensure that registered political parties have a broad base of financial support.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

A non-refundable tax credit is available for contributions to registered federal political parties or candidates. The credit is earned at a rate of 75 per cent on the first $100 contributed, 50 per cent on the next $450 contributed and $33^1/_3$ per cent on the next $600 contributed. The maximum credit is $500 and is available when the taxpayer has contributed $1,150.

This measure constitutes a tax expenditure because political contributions are not incurred to earn income.

Special Tax Computation for Certain Retroactive Lump-Sum Payments

Objective: *This provision is intended to ensure that governments do not unduly benefit as a result of amounts being received in a lump sum. (Budget Plan 1999.)*

The 1999 budget permitted taxpayers receiving qualifying retroactive lump-sum payments to use a special mechanism to compute the tax on those payments. To be eligible for the special tax calculation, the right to receive the income must have existed in a prior year. In addition, the principal portion of the lump-sum payment must be at least $3,000, and must have been received in any year after 1994. The tax under the special mechanism is the federal tax that would have been payable if the principal portion of the retroactive lump-sum payment had been taxed in the year to which it relates, plus interest to reflect the delay in receiving the tax.

The tax expenditure under this item is equal to the difference between the tax that would be owed on the principal portion of eligible retroactive lump-sum payments if they were taxed in the year received, and the tax computed under the special mechanism. There is no tax expenditure associated with the interest element of any lump-sum payment because it is fully included in income for the year in which it is received.

Non-Taxation of Income of Indians on Reserves

Objective: *This exemption reflects provisions under section 87 of the Indian Act.*

Section 87 of the Indian Act exempts the personal property of a status Indian and Indian bands from taxation if such personal property is situated on a reserve. Courts have held that the term "personal property" includes income. Determining whether income is situated on a reserve requires an examination of the factors that connect it to a reserve. With respect to employment income, for example, a key factor is the location (on or off a reserve) at which the employment duties were performed.

No data are available.

Non-Taxation of Gifts and Bequests

Objective: *This exemption recognizes the difficulties associated with the valuation and reporting of the many small gifts of a routine nature exchanged between individuals and families. (Report of the Royal Commission on Taxation, 1966, vol. 3.)*

Gifts and bequests are not included in the income of the recipient for tax purposes.

No data are available.

Memorandum Items

Non-Taxation of Lottery and Gambling Winnings

> ***Objective:*** *Proceeds from the sale of lottery tickets are an important source of funds for provincial governments, charities and other not-for-profit organizations. As a result, there is already a considerable element of taxation to lottery and gambling proceeds. The federal government has vacated this area in favour of the provinces.*

Lottery and gambling winnings are excluded from income for tax purposes.

The estimate for the non-taxation of winnings in government lotteries is based on information provided by Statistics Canada. Values for the non-taxation of winnings from horse racing are estimated using data provided by Agriculture and Agri-Food Canada. The values do not include winnings from other types of gambling, such as bingo and casino winnings where no accurate data are available.

The tax expenditure estimate assumes that the total amount of lottery and horse racing winnings would be included in income and subject to tax. This would likely not be the case because there would be large administrative costs in taxing thousands of small prizes, in particular instant win lotteries. A threshold below which winnings would be non-taxable would result in substantially lower revenues. It should also be noted that proceeds from the sale of lottery tickets are an important source of funds for provincial governments and not-for-profit organizations. As a result, there is already a considerable element of taxation to lottery and gambling proceeds. This estimate is therefore included as a memorandum item only.

Non-Taxation of Specified Incidental Expenses

> ***Objective:*** *This provision recognizes the additional costs incurred by certain public officials in the course of their public duties. (Budget Speech, 1946.)*

Members of Parliament (MPs), members of legislative assemblies (MLAs), senators and some other public officials (such as elected municipal officials and judges) receive flat allowances for expenses incidental to their duties. These amounts are not included in income for tax purposes. This provision is a memorandum item because it is not possible to distinguish the proportion of these allowances that is used for personal consumption and that which is for work-related expenses.

Data are available only for the non-taxable allowances provided to MPs, MLAs and senators. This information is found in the publications *Canadian Legislatures* and *The Canadian Parliamentary Guide*.

Non-Taxation of Allowances for Diplomats and Other Government Employees Posted Abroad

Objective: *This provision recognizes the additional costs incurred by diplomats and other government personnel employed outside Canada.*
(Section 6(1)(b)(iii), Income Tax Act.)

Diplomats and other government employees posted abroad receive an allowance to cover the additional costs associated with living outside Canada. These allowances are not taxable.

Information on total allowances was obtained from the Treasury Board of Canada Secretariat.

Child Care Expense Deduction

Objective: *This provision recognizes the child care costs incurred by single parents and two-earner families in the course of earning business or employment income, pursuing education or performing research.*
(Budget Papers, 1992. Budget Plan, 1998.)

Child care expenses incurred for the purpose of earning business or employment income, taking an occupational training course or carrying on research for which a grant is received are deductible, up to a limit. Prior to 1998, the deduction could not exceed the lesser of $5,000 per child under age 7 or having a disability and $3,000 per child between 7 and 14 years of age or being infirm (16 years after 1995); two-thirds of earned income for the year; and the actual amount of child care expenses incurred. After 1995, the two-thirds earned income limit does not apply to single parent students.

The spouse with the lower income must generally claim the deduction. However, the higher-income parent may claim a deduction if the lower-income parent is infirm, confined to a bed or a wheelchair, in prison, or attending a designated educational institution on a full-time basis.

The 1998 budget increased the deduction limits by $2,000 to $7,000 per child under age 7 or having a disability and by $1,000 to $4,000 per child between 7 and 16 years of age or being infirm. The 1998 budget also allowed child care expenses incurred by an individual in order to pursue part-time education to be claimed, subject to certain limits. The 2000 budget enhanced the child care expense deduction for families with a child having a disability by increasing the deduction limit to $10,000 from $7,000 for a child eligible for the disability tax credit.

Attendant Care Expense Deduction

> ***Objective:*** *This provision recognizes the costs incurred by disabled taxpayers for care by an attendant required to enable the taxpayer to earn business or employment income. In so doing, the provision increases equity between the able-bodied earners and those who incur additional expenses owing to a disability. (Budget Papers, 1989.)*

A disabled individual can deduct the cost of unreimbursed care provided by an attendant, if such an expense is required to enable the individual to work. For taxation years 1994 to 1997, the deduction cannot exceed the lesser of $5,000 and two-thirds of earned income for the year. The 1997 budget eliminated the $5,000 limit on attendant care expenses. The 2000 budget proposed to expand the attendant care deduction to include individuals attending a designated educational institution or a secondary school.

Moving Expense Deduction

> ***Objective:*** *This provision facilitates labour mobility by allowing taxpayers greater flexibility in pursuing new employment and business opportunities anywhere in Canada. (Budget Speech, 1971. Budget Plan, 1998.)*

Most reasonable moving expenses incurred to earn employment or self-employment income at a new location (e.g., transportation, meals and temporary accommodation, cost of selling a former residence) are deductible from earnings or business income received after the move if the taxpayer moves at least 40 kilometres closer to the new place of employment or study. The deduction has to be claimed in the year or in the following year if it exceeds earnings at the new location in the year of the move. Prior to 1998, most moving expense reimbursements provided by employers were not included in income. The 1998 budget included certain employer-provided reimbursements in income, and allowed an offsetting deduction to the same extent as permitted for self-paid expenses. The 1998 budget also expanded the definition of relocation costs eligible for deduction.

The estimates do not include non-taxable reimbursements received from employers.

Deduction of Carrying Charges Incurred to Earn Income

> ***Objective:*** *This provision recognizes that carrying charges are incurred for the purpose of earning income.*

Interest and other carrying charges, such as investment counselling fees and safety deposit box charges, incurred to earn business or investment income are deductible.

Some might consider the deductibility of such expenses to be a tax expenditure because of the tax deferral arising from the up-front deduction of expenses associated with the earning of income that will not be taxed until possibly received in future years. Others would hold that carrying charges are incurred for the purpose of earning income and therefore represent part of the benchmark income tax system.

Deduction of Meals and Entertainment Expenses

> ***Objective:*** *To reflect the existence of the personal consumption element of meal and entertainment expenses, only 50 per cent of these costs are deductible. (Tax Reform 1987. Budget Papers, 1994.)*

Meals and entertainment expenses are considered to be a memorandum item because the amount that should be deductible under a benchmark tax system is debatable. While a portion of these expenditures is incurred in order to earn income, there is an element of personal consumption associated with these expenditures. Consequently, only a partial deduction for these expenses would be permitted under the benchmark tax system.

The deduction is limited to 50 per cent of the cost of food, beverages and entertainment.

The estimates provided reflect the additional tax revenue that would be received if no deduction were allowed (i.e., that there is no business purpose to the expenditure).

Deduction of Farm Losses for Part-Time Farmers

> ***Objective:*** *This provision allows for the limited deductibility of farm losses for part-time farmers to recognize that cash basis accounting can distort the actual financial position of a farming business. (Sections 31, 111(3), Income Tax Act.)*

Individuals whose major source of income is not farming are allowed to deduct farm losses against other income up to an annual maximum of $8,750.

Part-time farm losses that are not deductible in the current year may be carried back 3 years and forward 10 years to deduct against farm income. The estimates include the cost of these carry-overs.

Farm and Fishing Loss Carry-overs

> ***Objectives:*** *These measures provide increased cash flows and reduced risks to farms and fisheries in recognition of the cyclical nature of these industries. (Budget Papers, 1983.)*

Farm and fishing losses may be carried back 3 years and forward 10 years. Most other business losses may be carried forward only 7 years.

The only data that are available are prior years' losses carried forward to the current year. In this regard, the estimates do not include current year losses carried forward or back to other taxation years, nor do they include future losses carried back to the taxation year in question. The estimates do not include losses carried over by part-time farmers.

Capital Loss Carry-overs

> ***Objective:*** *These provisions support businesses and investors by reducing the risk associated with investment, and provide tax relief for cyclical businesses. (Budget Papers: Supplementary Information, 1983.)*

Net capital losses may be carried back three years and forward indefinitely to offset capital gains of other years. The only data that are available are prior years' losses carried forward to the current year to reduce taxes payable. The estimates do not include current year losses carried forward or back to other taxation years, nor do they include future losses carried back to the taxation year in question.

Non-Capital Loss Carry-overs

> ***Objective:*** *These provisions support businesses and investors by reducing the risk associated with investment, and provide tax relief for cyclical businesses. (Budget Papers: Supplementary Information, 1983.)*

Non-capital losses may be carried back three years and forward seven years to offset other income. The only data that are available are prior years' losses carried forward to the current year to reduce taxes payable. Thus, the cost estimates may understate the true amount of revenue forgone because they do not include current year losses carried forward or back to other taxation years nor do they include future losses carried back to the taxation year in question.

Logging Tax Credit

> ***Objective:*** *The logging tax credit was introduced as a means of relieving the tax burden on the forest industry. (Budget Speech, 1962.)*

The logging tax credit reduces federal taxes payable by the lesser of two-thirds of any logging tax paid to a province and $6^2/_3$ per cent of income from logging operations in that province.

Deduction of Resource-Related Expenditures

> ***Objective:*** *This provision was introduced to encourage the development of Canada's natural resources. (Budget Speech, 1961.)*

Individuals are entitled to deduct certain expenses associated with the exploration for, and development of, Canadian natural resources. These expenses are deductible if the taxpayer either engages directly in these resource activities or provides financing to a resource company which, in turn, "flows through" the tax deductions to the taxpayer.

A tax expenditure arises when a flow-through share investor is able to use deductions for exploration and development more quickly than would otherwise have been possible by the resource company that actually undertook these expenditures. This may be because the taxpayer has otherwise-taxable income in a year and the corporate issuer of the flow-through does not. It may also be the direct result of a special provision for junior oil and gas companies whereby expenses that would otherwise be deductible at 30 per cent can be deducted at 100 per cent when "flowed through" using flow-through shares.

However, the available data do not permit a separation of expenses that are flowed through to investors and those that are incurred directly by the taxpayers. Accordingly, only some portion of resource-related expenditures deducted represents a true tax expenditure. Consequently, the total cost of all these deductions has been calculated, but these amounts are treated as a memorandum item.

Reclassification of Flow-Through Shares

Objective: *This provision was introduced in order to facilitate financing and to promote investment in the junior oil and gas sector.*
(Economic and Fiscal Statement, 1992; Budget Plan 1996.)

The costs incurred by an oil and gas company in exploring for a new reservoir of crude oil or natural gas are generally classified as a Canadian exploration expense (CEE) and are deductible at 100 per cent in the year they are incurred. The costs of drilling production wells into a reservoir after it has been discovered are generally classified as Canadian development expenses (CDEs) and are deductible at 30 per cent on a declining balance.

The 1992 budget introduced a measure that allowed for reclassification of CDEs into CEEs. The first $2 million of CDEs for oil and gas that were renounced by a company to shareholders under a flow-through share agreement could be reclassified as CEEs and deducted by shareholders accordingly – 100 per cent in the first year rather than 30 per cent per year on a declining balance basis. The 1996 budget reduced the limit to $1 million and restricted reclassification to issuing corporations with less than $15 million in taxable capital employed in Canada. These changes were introduced to better focus this incentive on smaller oil and gas companies that have a relatively greater need for assistance in raising new equity capital. The limit on reclassification applies on an annual basis to each company or associated group of companies. Consistent with the treatment of CEEs, eligible expenses incurred in the first 60 days of a year will be treated as having been incurred in the previous year.

This item is a subset of the tax expenditures associated with deductions of resource-related expenditures.

Deduction of Other Employment Expenses

Objective: *This provision recognizes that certain expenses must be incurred for the purpose of earning employment income.*

Employees generally cannot deduct work-related expenses. However, specific employment expenses (e.g., automobile expenses, cost of meals and lodging for certain transport employees, legal expenses paid to collect salary) are deductible in certain circumstances in the computation of income. This provision is a memorandum item because it is not possible to distinguish the proportion of these expenses that is used for personal consumption and that which is incurred in order to earn income.

Deduction of Union and Professional Dues

> ***Objective:*** *This provision recognizes that these payments are of a mandatory nature and are therefore incurred to earn income. (Budget Speech, 1951.)*

Union and professional dues are fully deductible from income. The mandatory nature of these payments leads to their classification as expenses incurred to earn income.

Employment Insurance Contribution Credit/Non-Taxation of Employer-Paid Premiums

> ***Objective:*** *This provision recognizes that these payments are of a mandatory nature and are therefore incurred to earn income.*

A 17-per-cent tax credit is provided for employment insurance (EI) contributions. Employer-paid premiums are not included in the employee's income. The mandatory nature of EI contributions leads to their classification as expenses incurred to earn income.

Canada Pension Plan and Quebec Pension Plan Contribution Credit/Non-Taxation of Employer-Paid Premiums

> ***Objective:*** *This provision recognizes that these payments are of a mandatory nature and are therefore incurred to earn income.*

A 17-per-cent tax credit is provided for Canada Pension Plan/Quebec Pension Plan contributions by both employees and the self-employed. Employer-paid premiums are not included in the employee's income. Since CPP/QPP contributions are mandatory, they are classified as expenses incurred to earn income.

Foreign Tax Credit

> ***Objective:*** *This provision was introduced to avoid the double taxation of income that has already been taxed in foreign countries.*

In order to avoid double taxation, a tax credit is provided in recognition of income taxes paid in foreign countries.

Dividend Gross-Up and Credit

> ***Objective:*** *These provisions contribute to the integration of the corporate and personal income tax systems in order to reduce the double taxation effect of taxing income at both the corporate and personal level.*

Dividends received from taxable Canadian corporations are "grossed up" by a factor of one-quarter and included in income. A tax credit equal to 13.33 per cent of the grossed-up amount is then provided, in recognition of taxes paid at the corporate level. These provisions contribute to the integration of the corporate and personal income tax systems.

Supplementary Low-Income Credit

Objective: *This provision provides tax relief to low-income Canadians. (Budget Plan, 1998.)*

The 1998 budget introduced a supplement of $500 to the basic personal, spousal and equivalent-to-spouse non-refundable tax credits for low-income taxfilers. The supplementary amount for a single individual was reduced by 4 per cent of income in excess of $6,956. The total amount available to an individual with an eligible dependant was reduced by 4 per cent of the filer's income minus the total of $6,956 and the dependant's adjusted income. The 1999 budget extended the benefit of this credit to all taxpayers through the basic personal and spousal/equivalent-to-spouse credits effective July 1, 1999.

Basic Personal Credit

Objective: *This provision contributes to tax fairness by ensuring that no tax is paid on a basic amount of income. (Report of the Royal Commission on Taxation, 1966, vol. 3. Budget Speech, 1998.)*

Until 1997, all taxpayers qualified for a basic personal credit equal to 17 per cent of $6,456. The 1998 budget increased the basic personal credit to 17 per cent of $6,956 effective July 1, 1998, and the 1999 budget increased it to 17 per cent of $7,131, effective July 1, 1999. The 2000 budget proposed full indexation effective January 1, 2000, which will increase the credit to 17 per cent of $7,231 for the 2000 taxation year.

Non-Taxation of Capital Dividends

Objective: *This treatment contributes to the integration of the corporate and personal income tax systems in order to avoid double taxation.*

Private corporations may distribute the exempt one-quarter of any realized capital gains accumulated in their "capital dividend account" to their shareholders in the form of a capital dividend. This dividend is non-taxable. This measure is reported as a memorandum item since it contributes to the integration of the taxation of corporate and personal income.

No data are available.

Chapter 3

Description of Corporate Income Tax Provisions

The descriptions of the specific tax measures contained in this chapter are intended as a simplified reference and are not detailed descriptions of specific tax measures.

Tax Rate Reductions

The following items are measures that reduce the statutory tax rate faced by a corporation. They are considered to be tax expenditures because income is taxed at a rate other than the generally applicable tax rate.

Low Tax Rate for Small Businesses

> ***Objective:*** *This lower tax rate is intended to provide small corporations with more after-tax income for reinvestment and expansion. (Tax Measures: Supplementary Information, February 22, 1994.)*

Corporations that are Canadian-controlled private corporations (CCPCs) are eligible for a lower federal tax rate of 13.12 per cent (12 per cent plus surtax) on the first $200,000 of active business income.

Effective July 1, 1994, CCPCs with more than $15 million of taxable capital employed in Canada are no longer eligible for this rate reduction. In addition, CCPCs with between $10 million and $15 million of taxable capital employed in Canada have reduced access to the small business deduction.

Low Tax Rate for Manufacturing and Processing

> ***Objective:*** *This lower tax rate is intended to enhance the international competitiveness of the manufacturing industry. (Income Tax Reform, June 18, 1987.)*

Canadian manufacturing and processing income not eligible for the small business deduction is subject to a lower federal tax rate of 22.12 per cent (21 per cent plus surtax).

The 1999 budget proposed a phased-in extension of this lower tax rate to corporations that produce electrical energy or steam for sale.

The 2000 budget proposed a phased-in extension of this lower tax rate to corporations that produce, for sale, steam for uses other than the generation of electricity.

Low Tax Rate on General Income of Small Businesses

> ***Objective:*** *This lower tax rate is intended to ensure that small businesses benefit from lower corporate tax rates more rapidly. (The Budget Plan 2000, February 28, 2000.)*

The 2000 budget proposed that, effective January 1, 2001, the federal corporate income tax rate on income between $200,000 and $300,000 earned by a Canadian-controlled private corporation from an active business carried on in Canada be reduced to

22.12 per cent (21 per cent plus surtax). Income eligible for this lower rate will be reduced to the extent that the corporation has manufacturing and processing (M&P) income subject to the reduced M&P tax rate or income from resource activities.

Low Tax Rate for Credit Unions

> ***Objective:*** *The purpose of the low tax rate for credit unions is to permit a credit union to accumulate capital on a tax-preferred basis up to a maximum of 5 per cent of deposits and capital.*

Although not a private corporation for most purposes, a credit union is eligible for the lower federal tax rate of 13.12 per cent (12 per cent plus surtax) provided to small businesses. A credit union with more than $200,000 of active business income may be eligible for this lower rate on income in excess of the $200,000 limit where the total income of the corporation since 1971 is less than the corporation's "maximum cumulative reserve," which is equal to 5 per cent of amounts owing to members (including members' deposits and share capital).

Exemption From Branch Tax for Transportation, Communications, Banking and Iron Ore Mining Corporations

> ***Objective:*** *Exemptions from branch tax are in recognition of the fact that certain foreign companies sometimes have no real alternative to the branch office form of organization when operating in other jurisdictions. For example, this is often the case for Canadian mining ventures that are jointly financed by Canadian and foreign interests and require large amounts of capital investment. (Budget Speech, April 10, 1962.)*

The branch tax is imposed on that portion of the income of non-resident corporations derived from the carrying on of business in Canada through a branch. If a Canadian branch has ceased active business operations, non-residents are liable for tax on capital gains on dispositions of taxable Canadian property. The rate is 25 per cent, but is frequently reduced by bilateral tax treaties to 15 per cent, 10 per cent or 5 per cent.

A corporation is exempt from the branch tax if it is:

- a bank;
- a corporation whose principal business is:
  - the transportation of persons or goods;
  - communications; or
  - mining iron ore in Canada; or
- an exempt corporation such as a registered charity.

Legislation will be introduced in Parliament to make foreign bank branches subject to the branch tax effective as of June 28, 1999.

No data are available.

Exemption From Tax for International Banking Centres

> ***Objective:*** *In order to broaden our trade and business interests in Europe and the Pacific Rim, this measure exempts international banking centres established in Montréal and Vancouver. This measure is also intended to return to Canada some banking activities previously conducted abroad and to attract business that normally wouldn't be conducted in Canada. (Department of Finance Release 87-16, January 28, 1987.)*

A prescribed financial institution's branch or office carrying on certain business in the cities of Montréal or Vancouver may qualify as an international banking centre (IBC) and therefore be exempt from tax on its income. To qualify as an IBC under the Income Tax Act, the branch's income must be derived from accepting deposits and making loans to non-residents. This measure, introduced in 1987, is considered a tax expenditure because a financial institution can undertake business with non-residents through a Canadian permanent establishment without being subject to Canadian income taxes.

No data are available.

Tax Credits

Investment Tax Credits

The following measures are credits against federal income taxes otherwise payable. They are considered to be tax expenditures because they provide incentives to taxpayers that invest in certain activities, such as scientific research and experimental development (SR&ED), or in certain capital assets in designated regions of the country.

The amount of an investment tax credit (ITC) is calculated as a percentage of the cost of eligible expenditures. ITCs can reduce federal income tax revenues in one of two ways. They may be:

- used to offset federal income taxes otherwise payable; or
- fully or partially refunded in the year they are incurred in the case of smaller Canadian-controlled private corporations (CCPCs).

Certain ITCs earned in a year may be refunded to individuals and qualifying corporations that cannot use them to reduce federal income taxes otherwise payable. The rate of refundability for these ITCs is generally 40 per cent. However, a qualifying CCPC may receive a refund of 100 per cent on SR&ED ITCs earned at the 35-per-cent rate in respect of up to $2 million of eligible current expenditures.

For the purposes of the refund, a qualifying corporation is generally a CCPC with taxable income not exceeding $200,000 in the preceding year. However, in the case of the SR&ED ITC, refundability phases out as the prior-year taxable income of a CCPC (or associated corporate group) rises above $200,000 and is eliminated entirely at $400,000. In order to focus ITC benefits on smaller CCPCs, the 1994 budget introduced a change to phase out refundability after 1995 for CCPCs with taxable capital employed in Canada exceeding $10 million and to fully eliminate refundability for CCPCs with taxable capital employed in Canada exceeding $15 million.

All refunds reduce the amount of ITC for carry-over purposes. Unused ITCs may be carried forward 10 years or back 3 years.

ITCs utilized or refunded in a year reduce either the undepreciated capital cost of the asset for capital cost allowance purposes or, in the case of SR&ED, the SR&ED pool. Credits earned in respect of a property acquired after 1989 and not immediately available for use may not become claimable or refundable until the property is available for use or has been held by the taxpayer for 2 years.

Issues in Calculating the Value of ITCs

To maintain consistency with the other tax expenditures estimates, the amounts estimate the forgone revenue for the year in question from each ITC. In other words, the estimates show how much additional revenue would have been collected by the Government in the year if the ITC had been eliminated in that particular year. To do this, the amount of ITCs used in the year are separated into three components: ITCs that were both earned and used in the year, ITCs that were earned in the current year but were carried back and applied to reduce tax of a previous year, and ITCs that were earned in prior years but were carried forward and used in the year. The first represents credits in respect of current year expenditures. The costs of any applicable refunds of ITCs earned are included in these estimates. The latter two items – ITCs carried over to other years – are itemized separately as an aggregate for all ITCs.

Another perspective on the revenue cost of each ITC may be obtained by looking at the amount of ITCs earned in a specific year. This information is provided in the following table for 1995 and 1996. However, it should be recognized that ITCs earned in the year are not necessarily used in the year – they may be used in a subsequent or previous year, subject to the carry-over rules. As a result, had the ITCs been eliminated, government revenues for the year would not have been higher by the amounts shown in the following table since it may take a number of years for ITCs earned in a year to be used by the taxpayer to reduce federal taxes.

Investment Tax Credits Earned in the Year

	1995[1]	**1996**
	($ millions)	
SR&ED ITC	1,619	1,676
Atlantic ITC	307	330
Special ITC	33	n.a.

[1] The 1995 figures are based on final data and differ from the figures in last year's edition of the tax expenditures document, which were based on preliminary data.

Scientific Research and Experimental Development Investment Tax Credit

> ***Objective:*** *The federal income tax incentives for scientific research and experimental development (SR&ED) provide broadly based support for all types of SR&ED performed in every industrial sector in Canada. The rationale for this tax support is that the benefits of SR&ED extend beyond the performers themselves to other firms and sectors of the economy. The existence of these spillovers or externalities mean that, in the absence of government support, firms would likely perform less SR&ED than desirable from the economy's point of view.*
>
> *Federal tax policy objectives in supporting SR&ED are to: encourage SR&ED to be performed in Canada by the private sector through broadly based support; assist small businesses to perform SR&ED; provide incentives that are, as much as possible, of immediate benefit; provide incentives that are as simple to understand and comply with and as certain in application as possible; and promote SR&ED that conforms to sound business practices.*
>
> *Federal income tax incentives for SR&ED assist the private sector in developing new products and processes, improving productivity, enhancing competitiveness and growth, and creating jobs for the benefit of all Canadians. (Budget Plan, March 6, 1996.)*

There were three rates of SR&ED ITCs prior to 1995: a general rate of 20 per cent; an enhanced rate of 35 per cent for CCPCs with prior-year taxable income of less than $200,000; and a rate of 30 per cent for the Atlantic provinces and the Gaspé region. The latter rate was eliminated in the 1994 budget effective after 1994. The maximum amount of SR&ED expenditures that can earn ITCs at the 35-per-cent rate in a year is $2 million.

The SR&ED ITC is earned on eligible current and capital expenditures in respect of SR&ED in Canada performed by, or on behalf of, a taxpayer and related to a business of the taxpayer.

Atlantic Investment Tax Credit

> ***Objective:*** *The objective of the Atlantic investment tax credit (AITC) is to promote economic development (i.e., investment, thereby increasing productivity and employment) in the Atlantic provinces and the Gaspé region.*
> *(Budget Plan, March 1977)*

Prior to 1995, the AITC was available at a rate of 15 per cent in respect of eligible expenditures in the Atlantic region – i.e., Newfoundland, New Brunswick, Nova Scotia, Prince Edward Island, the Gaspé region and their associated offshore areas. The 1994 budget reduced the AITC rate to 10 per cent for eligible expenditures incurred after 1994.

The AITC is earned on eligible expenditures on new buildings, machinery and equipment employed in the following qualifying activities: farming, fishing, logging, mining, oil and gas, and manufacturing and processing.

The AITC is refundable at a rate of 40 per cent for qualifying CCPCs and individuals.

Special Investment Tax Credit

> ***Objective:*** *The objective of the special investment tax credit (SITC) was to promote regional development by encouraging foot-loose manufacturing activities to locate within qualifying regions of low growth and high unemployment across Canada.*
> *(Budget Plan, 1980)*

Prior to 1995, the SITC was provided at a rate of 30 per cent for eligible expenditures on new buildings, machinery and equipment used in qualifying activities in qualifying regions of Canada. The SITC was eliminated in the 1994 budget, effective January 1, 1995. However, certain activities in the Atlantic region continue to be eligible for the AITC.

Qualifying activities were defined under the Regional Development Incentives Act and its regulations, and generally included manufacturing and processing facilities located in a qualifying region, with the exception of certain primary processing of natural resources.

Qualifying regions included northeastern British Columbia, northwestern Alberta, northern Saskatchewan, most of Manitoba, northern Ontario, northern Quebec and the Gaspé region, and areas of Atlantic Canada.

Investment Tax Credits Carried Back

These are tax credits that were earned by corporations in the current taxation year and were carried back to the three previous taxation years to reduce federal taxes otherwise payable in those years.

Investment Tax Credits Claimed in Current Year but Earned in Prior Years

These are tax credits that were earned by corporations in previous years but not claimed until the current year. There is a revenue cost to the Government when the credits are used by corporations to reduce federal taxes payable. While the aggregate amount of these credits is known with some confidence, there is not enough information available to identify separately the amounts for each credit.

Political Contribution Tax Credit

> ***Objective:*** *This provision is intended to ensure that registered political parties have a broad base of financial support.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

A non-refundable tax credit is available for contributions to registered federal political parties or candidates. The credit is earned at a rate of 75 per cent on the first $100 contributed, 50 per cent on the next $450 contributed and $33^1/_3$ per cent on the next $600 contributed. The maximum credit is $500 and is available when the taxpayer has contributed $1,150.

This measure constitutes a tax expenditure because political contributions are not incurred to earn income.

Canadian Film or Video Production Tax Credit

Objective: *The film tax credit is intended to subsidize the Canadian film and video production industry.*
(Budget Speech, February 27, 1995, and Budget Plan, February 27, 1995.)

The Canadian film or video production tax credit was introduced in the 1995 budget for certified Canadian film productions produced by qualified corporations. It provides a refundable investment tax credit of 25 per cent of the cost of eligible salaries and wages expended after 1994, except where the financing of the film is eligible for transitional relief from the termination of the capital cost allowance (CCA) film incentive. Eligible salaries and wages are limited to 48 per cent of the cost of production, so that the credit provides assistance of up to 12 per cent of the cost of the production. Canadian film or video productions are certified by the Minister of Canadian Heritage.

This tax credit was intended to retarget government assistance available to Canadian film productions in order to maximize the benefit to such productions. It replaced a tax shelter of accelerated CCA deductions used principally by higher-income individuals, with a refundable tax credit for eligible films produced by qualified taxable Canadian corporations.

Film or Video Production Services Tax Credit

Objective: *The film or video production services tax credit makes Canada a more attractive place for film production by complementing the existing Canadian film or video production tax credit and by allowing a greater range of productions (usually foreign-owned) to qualify for assistance. The tax credit provides economic development assistance to film and video productions produced in Canada. The tax credit was effective beginning November 1, 1997, to coincide with the elimination of film production services tax shelters.*

The production services tax credit applies to film or video production services that are provided in Canada for films that do not have sufficient Canadian content to qualify for the Canadian film or video production tax credit. It is a refundable credit of 11 per cent of salaries and wages paid to Canadian residents for services performed in Canada after October 31, 1997. The Canadian Audio-Visual Certification Office of Canadian Heritage provides certificates of eligibility.

The tax credit is designed to retarget government assistance by making the benefit available directly to the production services provider. Previously, this assistance was provided through syndicated tax shelters for such productions.

Exemptions and Deductions

The following exemptions and deductions are considered tax expenditures because they deviate from the benchmark tax system.

Partial Inclusion of Capital Gains

> ***Objective:*** *The reduced rate of inclusion for capital gains provides incentives to Canadians to save and invest, and to ensure that Canada's treatment of capital gains is broadly comparable to that of other countries.*
> *(Proposals for Tax Reform, 1969. Tax Reform 1987: The White Paper, 1987.)*

Only a portion of net realized capital gains are included in income. The amount of the tax expenditure is the additional tax that would have been collected had the full amount of the capital gains been included in income. However, this amount is likely an overestimate of the true amount of this tax expenditure. To the extent that the capital gains are from shares that have increased in value due to retained earnings, and which have already been taxed at the corporate level, the partial inclusion of the capital gains provides some relief from double taxation and, therefore, should be part of the benchmark tax system. The 2000 budget proposed to reduce the capital gains inclusion rate from three-quarters to two-thirds effective February 28, 2000.

The 1997 budget reduced the inclusion rate on capital gains arising from certain donations to charities (other than private charitable foundations) to one-half of the regular inclusion rate. Donations eligible are those of securities that are listed publicly on a recognized stock exchange in Canada, where the donation is made between February 18, 1997, and the end of the year 2001. The 2000 budget proposed that the inclusion rate also be reduced by one-half in respect of capital gains arising from gifts of ecologically sensitive land to qualified donees other than private foundations.

Royalties and Mining Taxes

Non-Deductibility of Crown Royalties and Mining Taxes

> ***Objective:*** *Prior to 1974, royalties in respect of the production of natural resources had traditionally been deductible as a business expense. On May 6, 1974, the federal government announced that it would deny the deduction of Crown royalties and provincial mining taxes. This action was taken in order to ensure that provincial royalties, provincial mining taxes and other arrangements having similar effects do not unreasonably erode the corporate income tax base.*
> *(Budget Speech, May 6, 1974.)*

The current tax system does not permit a deduction for Crown royalties or mining taxes. The deduction has been denied since May 6, 1974. From that time to the end of 1975, oil and gas and mining companies were eligible for a resource tax abatement of 10 and subsequently 12 percentage points for petroleum profits and 15 percentage points for mining income. This provided a lower rate of tax on oil and gas and mining income. A resource allowance (discussed below) was proposed in the June 1975 budget and replaced the resource tax abatement after 1975.

A negative tax expenditure is calculated for the non-deductibility of Crown royalties and mining taxes. A negative tax expenditure implies that the Government collects more income taxes than would have otherwise occurred in the benchmark system. The issue arises as to whether the benchmark tax system would include a deduction for all Crown royalties and mining taxes. Two generic types of non-deductible Crown charges are levied on the extraction of natural resources. One type is a simple royalty system where the Crown

charge is based only on gross revenues. There are also more complex systems of Crown charges that are based on net resource profits – i.e., resource profits after the deduction of numerous costs, including capital, operating costs and sometimes a return on capital employed.

In the case of Crown charges based on gross revenues, the benchmark system would include a deduction for these royalties since they are analogous to costs of production. However, the benchmark tax system would not include a deduction for the latter type of profit-related Crown royalties and mining taxes because they are structured more like income taxes. Provincial income taxes are not considered to be a deductible expense in the benchmark system. Provincial payroll and capital taxes, on the other hand, are deductible and they are not treated as tax expenditures.

The calculations shown in *Tax Expenditures and Evaluations* represent the federal corporate income tax revenues generated by the current rules, which deny the deductibility of all Crown royalties and mining taxes. No attempt has been made to divide the disallowed royalties into the two categories described above. This is in part due to the fact that many royalty systems include characteristics of both a gross and net calculation. Thus, the calculation represents an overestimate of the actual negative tax expenditure.

Resource Allowance

Objective: *The resource allowance came into effect in 1976. It replaced the resource tax abatements noted above. It was viewed as a better way of recognizing that provinces impose mining taxes and/or royalties and to take that fact into account, within reasonable limits, in determining taxable income.*

In addition, the resource allowance was designed to offer more incentives to those who explore and develop in Canada and to impose a greater tax liability on those who do not. (Budget Speech, June 23, 1975.)

Since 1976, the income tax system has provided a resource allowance deduction equal to 25 per cent of a taxpayer's annual resource profits, computed after operating costs and capital cost allowances, but before the deduction of exploration expenses, development expenses, earned depletion and interest expenses. These latter expenses were excluded from the resource profit calculation primarily to encourage companies to undertake exploration and development activities in Canada. The resource allowance is provided in lieu of the deductibility of Crown royalties, mining taxes and other charges related to oil and gas or mining production. The measure allows the provinces room to impose royalties or mining taxes on the production of natural resources while maintaining the federal income tax base. For analytical purposes, the value of the tax expenditure for the royalties and mining taxes is broken down into two components:

- the federal tax revenue earned by disallowing royalty deductibility (a negative tax expenditure, described above); and
- the federal tax revenue forgone resulting from the resource allowance deduction (a positive tax expenditure).

An approximation of the overall impact of the resource allowance measure (compared to the benchmark tax system) can be obtained by netting the two above effects.

Earned Depletion

> ***Objective:*** *The earned depletion incentive was designed to encourage taxpayers to undertake more exploration and development than they otherwise would.*
>
> *As part of the Government's 1987 tax reform initiative, the ability to earn new earned depletion allowance deductions was phased out. (Proposals for Tax Reform, 1969; Summary of 1971 Tax Reform Legislation; Budget Speech, May 6, 1974; Budget Speech, November 18, 1974; and The White Paper, Tax Reform 1987.)*

Earned depletion is an additional deduction from taxable income of certain exploration and development expenditures and other resource investments. Prior to 1990, taxpayers were entitled to earn an extra deduction of up to $33^1/_3$ per cent of most exploration and development expenses or the costs of assets related to new mines or major expansions. The deductions for earned depletion are generally limited to 25 per cent of the taxpayer's annual resource profits, although mining exploration depletion can be deducted against non-resource income. As in the case of a Canadian exploration expense or a Canadian development expense, earned depletion could be pooled (i.e., placed in a special account, and any remaining balance could be carried forward indefinitely for use in later years).

Additions to the depletion pools for earned depletion and mining exploration depletion were eliminated as of January 1, 1990. Deductions can still be made on the basis of existing depletion pools.

Under the benchmark tax system, a deduction for earned depletion would not be available.

Deductibility of Charitable Donations

> ***Objective:*** *This incentive is designed to support the important work of the charitable sector in meeting the needs of Canadians. (Report of the Royal Commission on Taxation, 1966, vol. 3. Budget Plan, 1996. Budget Plan, 1997.)*

Donations made by corporations to registered charities are deductible in computing taxable income within certain limits. Unused deductions may be carried forward for up to five years.

For years prior to 1996, this deduction was limited to 20 per cent of net income. The 1996 budget announced that the deduction limit would be raised to 50 per cent of net income plus 50 per cent of taxable capital gains resulting from the donation of property. The 1997 budget announced a further increase in the limit to 75 per cent of net income plus 25 per cent of the amount of taxable capital gains arising from the donation of appreciated capital property and 25 per cent of any capital cost allowance recapture arising from the donation of depreciable capital property. The percentage of income restrictions do not apply to gifts of ecologically sensitive land and certain gifts of cultural property.

This deduction would not be permitted under the benchmark tax system because these expenditures are not incurred to earn income.

Deductibility of Gifts to the Crown

> ***Objective:*** *Gifts made to Canada or to a province are deductible, within certain limits, to encourage such contributions. Note: The Income War Tax Act, 1917, permitted the deduction of contributions to the Patriotic and Canadian Red Cross Funds and any other patriotic fund approved by the Minister.*

Gifts made by corporations to Canada or a province are deductible in computing taxable income, within certain limits. Unused deductions may be carried forward for up to five years.

Prior to 1997 the amount deductible was limited only to the amount of income in a particular year. The 1997 budget restricted the deductible amount to 75 per cent of net income plus 25 per cent of the amount of taxable capital gains arising from the donation of appreciated capital property and 25 per cent of any capital cost allowance recapture arising from the donation of depreciable capital property. The percentage of income restrictions does not apply to gifts of ecologically sensitive land and certain gifts of cultural property.

This deduction would not be permitted under the benchmark tax system because these expenditures are not incurred to earn income.

Interest on Small Business Financing Loans

> ***Objective:*** *This measure was intended to help small businesses in financial difficulty, including farmers, to obtain loans at lower interest rates. (Budget 1992: Budget Speech, February 25, 1992.)*

Small businesses in financial difficulty are able to treat interest paid on small business financing (SBF) loans entered into between February 25, 1992, and the end of 1994 as a non-deductible payment, and SBF lenders are permitted to treat the interest received as a dividend – resulting in such interest being non-taxable to corporate lenders and individual lenders being eligible for a dividend tax credit. This tax treatment permitted lenders to reduce the interest charges to such small businesses while maintaining their after-tax rates of return.

Non-Deductibility of Advertising Expenses in Foreign Media

> ***Objective:*** *This measure ensures that control of periodicals and newspapers will remain in the hands of Canadians and supports the continued existence of a viable and original Canadian magazine industry. (House of Commons Debates, vol. 3, 1965. Finance Canada News Release 95-050, June 15, 1995.)*

Expenses for advertising in non-Canadian newspapers or periodicals or on non-Canadian broadcast media cannot generally be deducted for income tax purposes if they are directed primarily to a market in Canada. Deducting the cost of advertising in foreign periodicals or on television stations is not restricted if the advertising is to promote sales in foreign markets.

This treatment results in a negative tax expenditure since the deduction of an expense incurred to earn income is denied. Under the benchmark tax system, advertising expenses in foreign media incurred to gain or produce income from a business or property would be deductible whether targeted at foreign or domestic markets.

No data are available.

Non-Taxation of Provincial Assistance for Venture Investments in Small Business

> ***Objective:*** *Provinces have established venture capital corporations to provide investment capital for small businesses. The non-taxation of provincial assistance for venture investments in small business assists the successful working of such provincial plans. (Budget Papers, December 11, 1979.)*

Government assistance received by a corporation is normally either included in the corporation's income or reduces the cost basis of the assets to which the assistance relates for capital cost allowance purposes. There are a number of exceptions to this rule, including provincial assistance provided for venture capital investment under specified provincial programs. Under the benchmark tax system, this type of assistance would be included in the corporation's income or would reduce the cost basis of the related assets.

No data are available.

Deferrals

The tax expenditures in this section provide for a deferral of income taxes from the current to a later taxation year. They have been valued on a cash-flow basis (i.e., the forgone tax revenue associated with the additional net deferral in the year). The alternative way of valuing deferrals would be to calculate the value of the interest-free loan that is provided to the taxpayer when taxes are deferred to a later year.

Accelerated Write-off of Capital Assets and Resource-Related Expenditures

Objective: *Accelerated capital cost allowances (CCAs) are provided for capital assets since faster write-offs are one way in which incentives can be given for investment.*

Accelerated CCAs are also provided for certain energy conservation and electrical generating equipment. Initially, this acceleration was provided as a temporary incentive during the mid-1970s in response to the international escalation of oil prices and partly to promote "off-oil" initiatives.

It is recognized that the exploration for and development of mines and oil and gas deposits involve more than the usual industrial risks and that the scale of these risks is quite uncertain in most cases. As a result, accelerated write-offs are provided for certain exploration and development and capital costs expenses so that these costs can be deducted for tax purposes early enough so that taxes will be applied only when it is clear that a project will be profitable. (The Corporate Income Tax System: A Direction for Change, May 1985. Tax Measures: Supplementary Information, February 22, 1994. Proposals for Tax Reform, 1969.)

Under the benchmark tax system, corporations would be permitted an annual deduction for their use of capital assets based on their anticipated economic life. Using the cash-flow approach, the tax expenditure in any particular year would be calculated as the forgone tax revenue resulting from the difference between the deduction taken for tax purposes, usually CCA, and the true economic depreciation based upon the asset's useful economic life. These annual calculations of the impact on cash flow can provide some indication of the tax expenditures resulting from the accelerated deductions for capital assets, but they could also be very misleading.

Tax expenditure amounts are not provided because:

- differences between the deductions for tax purposes and economic depreciation may not accurately reflect the tax expenditure; and
- adequate data are not available to calculate with any degree of accuracy this tax expenditure.

There are instances when differences between the deductions for tax purposes and economic depreciation would not accurately reflect the tax expenditure. First, it should be noted that the accelerated deductions for tax purposes lead only to a deferral, not a permanent reduction, of tax payable. If CCA rates are higher than actual depreciation rates, then during the initial years, the CCA claim would exceed economic depreciation. However, in later taxation years, the reverse would occur (i.e., actual depreciation would exceed the amount allowed for tax purposes). These differences between CCA and actual depreciation would lead to a positive tax expenditure in the early years of asset ownership since higher CCA rates in the initial years are a tax incentive. However, in later years, the CCA claim would be less than actual depreciation, resulting in a negative tax expenditure, thus offsetting the previous tax expenditure to some extent. For the corporate sector in total, the aggregate tax expenditure in any particular year could be positive or negative depending upon the level of investment in the current and previous

years. As a result, the tax expenditure depends critically on the growth rate of investments. If the growth rate were zero, then, in the long run, one would expect no tax expenditure amount since the positive tax expenditures resulting from more recent asset acquisitions would be offset by the negative tax expenditures resulting from older assets – that is, in total, the annual tax depreciation claimed would be equal to the economic depreciation.

In addition, because CCA is a discretionary deduction, the cash-flow method could result in a tax expenditure being reported even if there is no acceleration of CCA rates (i.e., the CCA rates correspond with economic depreciation rates). A company has discretion to claim less than the maximum amount in a particular year. As a result, in that year, the cash-flow method would result in a negative tax expenditure. Because the company would now have a larger undepreciated balance for tax purposes, future CCA write-offs would be larger than the corresponding economic depreciation, thereby resulting in a positive tax expenditure in future years.

Finally, differences between CCA and economic depreciation may also result from the treatment of dispositions. For tax purposes, assets are generally grouped in pools with gains or losses on disposition adjusting the undepreciated balance, while gains and losses for economic depreciation purposes are recognized on an asset-by-asset basis.

Also, the asset cost for tax purposes may differ from the cost for economic depreciation purposes in that, for economic depreciation purposes, interest costs are often capitalized while, for tax purposes, such costs are generally expensed in the year incurred.

Because economic depreciation is difficult to determine, the deductions for capital assets reported by companies in their financial statements are often used as a substitute. However, financial statement depreciation may differ from economic depreciation. Furthermore, not all companies classify the capital asset deductions as depreciation or some other readily identifiable expense. For example, in the leasing industry, a lease may be classified as an operating lease for tax purposes with CCA being claimed, while for accounting purposes, it may be classified as a capital lease, in which case the corresponding accounting deduction may not be specifically identifiable. Since the costs written off for financial statement purposes for this sector cannot be precisely determined, it is not possible to estimate the related tax expenditure. More generally, adequate data are not available to calculate with any degree of accuracy this tax expenditure.

Although it may not be possible to estimate with any degree of accuracy the expenditure using the cash-flow approach, some indication of the magnitude of the tax expenditure relating to a particular accelerated write-off provision can be calculated by comparing the estimated discounted present value of the tax benefits resulting from acquisitions in a particular year under each of the two depreciation methods. For example, if the CCA rate is higher than the actual depreciation rate, the discounted present value of the benefit of being able to claim CCA would exceed the discounted present value of the benefit of the financial statement depreciation, thereby resulting in a measure of the positive tax expenditure or tax incentive that has been provided.

The number of asset classes with accelerated depreciation rates was reduced significantly when changes were introduced in 1988. As a result, many CCA rates now approximate the rate of economic or financial statement depreciation, and the associated tax expenditure related to accelerated depreciation provisions has been reduced. However, a few instances remain where the CCA rates are clearly accelerated – that is, the tax system allows a larger deduction from income for the first few years after the property is acquired than is applied for financial statement purposes. Some of the more significant of these accelerated CCA provisions are described below. Illustrations of the net present value of the benefit of some of the remaining accelerated CCA provisions are also provided.

Vessels (Class 7)

Vessels are generally included in class 7 and are subject to a maximum CCA rate of 15 per cent on a declining-balance basis. Accelerated CCA on a straight-line basis at a maximum rate of $33^1/_3$ per cent of the capital cost of the property is available in respect of a vessel, including furniture, fittings, radio communication equipment and other equipment if it was (a) constructed in Canada, (b) registered in Canada, and (c) not used for any purpose whatever before acquisition by the owner. These assets are depreciated over a four-year period, with $16^2/_3$ per cent written off in the first and fourth years, and $33^1/_3$ per cent written off in the second and third years.

Energy-Efficient Equipment (Class 43.1)

Class 43.1 was introduced in 1994. Eligibility for class 43.1 is described in regulations to the Income Tax Act. In general, the following types of equipment may qualify for inclusion in class 43.1: certain electrical generating equipment including co-generation and specified waste-fuelled electrical generation systems; active solar systems; small-scale hydroelectric installations; heat recovery systems; wind energy conversion systems; photovoltaic electrical generation systems above a minimum threshold level; geothermal electrical generation systems; and specified waste-fuelled heat production equipment. Assets included in class 43.1 are eligible for an accelerated CCA rate of 30 per cent on the decline-balance basis rather than the 8-per-cent rate provided to most electrical generating equipment (4 per cent provided for equipment acquired prior to February 28, 2000). Active solar systems, heat recovery systems and waste-fuelled heat production equipment must be used directly in connection with an industrial process to qualify as class 43.1 equipment. The 1999 budget included in class 43.1 equipment for the generation of electricity from gas that would otherwise be flared during the production of crude oil.

Class 43.1 is also subject to the "specified energy property" rules, which may reduce the amounts that can be deducted to less than 30 per cent of the unclaimed capital cost.

Canadian Renewable and Conservation Expenses

Objective: *The renewable energy and energy conservation sector faces difficulties in financing intangible costs. The Canadian Renewable and Conservation Expenses (CRCEs) address this concern by providing them with improved access to financing in the early stages of their operations when they may have little or no income to utilize the income tax deductions related to these expenses.*

The 1996 budget made the tax treatments of renewable and non-renewable energy sectors more similar by:

- *introducing a new category of expenditures (namely CRCEs) in respect of intangible costs that are analogous to those expenses that are renounced as Canadian exploration expenses, and are associated with the development of projects, the equipment for which is eligible for class 43.1 treatment;*
- *allowing this new class of expenditures to be fully deductible; and*
- *allowing these expenditures to be renounced to shareholders who have entered into a flow-through share agreement.*

(Budget 1996: Budget Plan.)

This category of expenses was introduced to provide for full deductibility of certain costs associated with the development of renewable energy projects and other projects for which the equipment is eligible for accelerated deductions under class 43.1. The cost of test wind turbines is also eligible to be claimed as a CRCE expense.

CRCE can be flowed out pursuant to a flow-through share agreement. It was introduced to provide a more equitable tax treatment for the financing of renewable and non-renewable energy projects.

Mining Assets

Certain mining buildings, machinery and equipment acquired for use at a new mine or a major expansion of an existing mine may qualify for an accelerated CCA rate of up to 100 per cent. A 25-per-cent increase in a mine's capacity is generally considered to be a major expansion.

These mining assets were previously included in class 28 and depreciated at a rate of 30 per cent. Acquisitions after 1987 are included in class 41 and depreciated at a rate of 25 per cent. In addition to the 25-per-cent allowance provided in class 41, a taxpayer owning such property and operating the mine may claim an additional allowance equal to the lesser of (1) the remaining undepreciated capital cost of property of the class, or (2) the income for the year from the new or expanded mine.

The 1996 budget announced income tax changes for oil sands projects. The objective of the changes was to provide a more equitable tax treatment for the two different oil sands extraction methods (mining and *in situ*). Mining methods involve the removal of overburden and the transportation of bituminous sands to a central processing facility where the oil (bitumen) is separated from the sand using hot water. With *in situ* operations, the oil is recovered from an underground reservoir by the application of heat or other techniques, which make the oil more mobile and capable of flowing from a well or wells.

The 1996 budget extended the accelerated CCA rules to the eligible depreciable capital costs for *in situ* projects. The tax treatment that previously had been available only for new mines (both mineral and oil sands) and major mine expansions was also extended to other capital investments, including large incremental capital costs that might not otherwise qualify as a major expansion (e.g., efficiency improvements and environmental protection). In the latter circumstance, all tangible capital expenditures incurred for all types of mines, including both types of oil sands projects, would qualify for accelerated CCA to the extent that, in a year, these capital costs exceeded 5 per cent of gross revenue from that mine or oil sands project in that year.

Capital Equipment Used for Scientific Research and Experimental Development

Eligible capital expenditures for the provision of premises, facilities or equipment used for scientific research and experimental development in Canada may be fully deducted in the year they are incurred. In the absence of this provision, these amounts would have been depreciable over several years. Under the benchmark tax system, expenditures that are capital in nature and designed to produce income in the future are depreciated over a period approximating that during which the income is expected to arise.

Exploration Costs and Pre-Production Development Expenses

Expenditures incurred in determining the existence, location, extent or quality of mineral resources and oil or gas, or incurred to develop mineral resources prior to commercial production in Canada, are classified as a Canadian exploration expense (CEE) and can be deducted for tax purposes at a rate of up to 100 per cent.

Generally accepted accounting principles allow companies to depreciate exploration expenditures on either a “full cost” or a “successful efforts” basis. The full cost method requires that all exploration costs, whether they result in new production or not, be capitalized and amortized as the reserves are depleted. The successful efforts method requires that only those costs that result in the discovery of reserves and have a benefit in terms of future revenues are capitalized; other costs are expensed as incurred. Most Canadian-controlled companies follow the full cost method, while foreign-controlled companies in Canada usually follow the successful efforts method.

The 100-per-cent write-off of CEEs for tax purposes is more rapid than the amounts used for financial statement purposes, especially for successful exploration. The fast write-off for CEEs provides a deferral of tax.

Under the benchmark tax system, corporations would be permitted an immediate deduction only for unsuccessful exploration expenditures. However, those costs associated with successful exploratory activities (i.e., those costs that result in producing assets for both the mining and oil and gas sectors) would be permitted a deduction based on an amortization over the life of the asset.

Under certain conditions, corporations entering into flow-through share agreements are entitled to reclassify limited amounts of a Canadian development expense (normally a 30-per-cent deduction on a declining-balance basis) into a CEE. The tax expenditure associated with this provision appears as a personal tax expenditure item since these deductions are taken by the purchasers of the flow-through shares, who are generally individuals.

Illustration

Assuming a taxable corporation makes a $100,000 investment in an eligible asset, the net present value of the income tax reduction resulting from accelerated CCA is presented in the following table. This illustration is based upon the federal corporate income tax rate that will generally apply to the related income in 2001 (unless otherwise indicated) and uses a discount rate of 8 per cent. The actual net present value of the reduced federal tax resulting from accelerated CCA will vary depending upon the tax status of the corporation, its effective tax rate and the amount of CCA actually claimed in future years. The following table presents the maximum value of the incentive assuming that firms can fully benefit from the accelerated CCA. The one exception is for the analysis of mining assets (see footnotes 2 and 3 below).

	CCA Class	Accelerated Rate	Baseline Tax Depreciation Rate	Net Present Value of Reduced Federal Tax Resulting From Accelerated CCA
Vessels	7	33$^{1}/_{3}$% straight-line	15% declining balance	$5,600
Electrical generating equipment using wind, solar and geothermal energy	43.1	30% declining balance	8% declining balance	$6,200[1]
Canadian Renewable and Conservation Expenses	Full write-off in year	Full write-off in year	30% declining balance	$3,700[1]
Mining assets				
Oil sands and *in situ* oil	41(a)	100% (subject to income restriction)	25% declining balance	$500 to $4,000[2]
Conventional mines	41(a)	100% (subject to income restriction)	25% declining balance	$500 to $1,300[3]
Scientific research and experimental development equipment[4]	Full write-off in year	Full write-off in year	30% declining balance	$4,700
Exploration costs for non renewable resources and pre-production development expenses for mines	Full write-off in year	Full write-off in year	30% declining balance	$4,800

1 These amounts reflect the fully phased-in value of the 1999 budget proposal to provide, by 2002, the manufacturing and processing profits deduction for the production of electrical energy for sale.

2 Accelerated CCA can be claimed only against income earned by the related project, not against total corporate income. The income of the project, in turn, depends *inter alia* on prices for oil/minerals. Therefore, the net present value of the federal tax reduction resulting from claiming accelerated CCA varies depending upon the amount of project income against which CCA may be claimed. The estimates in this table were based on the operating results of a range of existing and proposed oil sands mining and *in situ* oil sands projects as obtained from industry sources. The calculations result in a range of $500 to $4,000 per $100,000 investment; however, most oil sands projects would generally fall between $1,000 and $3,500.

3 For conventional mines, the analysis was based on hypothetical mine models developed by Natural Resources Canada. These models include a range of low and high profitability metal mines.

4 This is the value of the accelerated CCA deduction and doesn't include the benefit of scientific research and experimental development tax credits provided.

Allowable Business Investment Losses

> ***Objective:*** *Small businesses often have difficulty obtaining adequate financing. The allowable business investment loss rules provide special assistance for risky investments in small business. (Budget Papers, May 23, 1985.)*

Capital losses arising from the disposition of shares and debts are generally deductible only against capital gains. However, under the allowable business investment loss rules, a portion of capital losses in respect of shares or debts of a small business corporation may be used to offset other income. The 2000 budget proposed that this portion be reduced from three-quarters to two-thirds, effective February 28, 2000, as a consequence of the reduction in the capital gains inclusion rate.

Unused allowable business investment losses may be carried back three years and forward seven years. After seven years, the loss reverts to a capital loss and may be carried forward indefinitely.

The value of the tax expenditure is the amount of tax relief provided by allowing these losses to be deducted from other income in the year rather than being deducted against uncertain taxable capital gains in the future.

Holdback on Progress Payments to Contractors

> ***Objective:*** *In the construction industry, holdbacks are considered to become receivable by contractors or payable to subcontractors only upon satisfactory completion of the project in order to alleviate potential cash-flow difficulties for this sector.*

In the construction industry, contractors are typically given progress payments as construction proceeds. However, a portion of these progress payments (e.g., 10 per cent to 15 per cent) is often held back until the entire project is completed satisfactorily. The amount held back need not be brought into the income of the contractor until the project to which it applies is certified as complete, rather than when earned, as would be required in the benchmark tax structure. Where a contractor, in turn, withholds an amount from a subcontractor, costs equal to the amount of the holdback are not considered to have been incurred by the contractor and are not deductible until paid. The net impact of these two measures on a given contractor's tax liability depends on the ratio of holdbacks payable to holdbacks receivable. If holdbacks receivable are greater than holdbacks payable, there is a deferral of tax. If holdbacks payable exceed holdbacks receivable, there is a prepayment of taxes.

Increases in net holdbacks receivable or decreases in net holdbacks payable result in a positive estimate of the amount of the tax expenditure. Increases in net holdbacks payable or decreases in net holdbacks receivable result in a negative estimate.

Available for Use

> ***Objective:*** *Permitting capital cost allowance (CCA) and tax credits to be claimed in the second taxation year following the year of acquisition, even though the property may not have been put into use, is intended to reduce the potential impact upon projects with long construction periods.*
> *(Supplementary Information Relating to Tax Reform Measures, December 16, 1987.)*

Taxpayers may claim CCA and investment tax credits (ITCs) on eligible property at the earlier of the time it is put in use or in the second taxation year following the year of acquisition. Property that becomes eligible for CCA and ITCs by virtue of the two-year deferral rule could result in a significant mismatch of revenues and expenses that give rise to a tax deferral. This is a tax expenditure because taxpayers are allowed to claim deductions and tax credits on property before it is put in use.

No data are available as assets are pooled into classes and are not accounted for separately. Furthermore, assets are not identified as being "available for use" or "not available for use."

Capital Gains Taxation on Realization Basis

> ***Objective:*** *This treatment recognizes that, in many cases, it is difficult to estimate with accuracy the value of unsold assets, and that taxing the accrued gains on assets that have not been sold would be administratively complex and could create significant liquidity problems for taxpayers.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 3.)*

Capital gains are taxed upon the disposition of property and not on an accrual basis. This treatment results in a tax deferral. Under the benchmark tax system, capital gains would be fully included in income as they accrue.

However, since 1994, financial institutions and investment dealers have been required to report gains and losses on certain securities on an accrual basis (i.e., mark to market).

No data are available.

Expensing of Advertising Costs

> ***Objective:*** *It is often difficult to identify specific costs with specific revenue. Moreover, there is no certainty that any revenue will result from many types of expenditures. As a result, for tax and accounting purposes, it is usual to write off against income most of these expenditures when incurred. Therefore, advertising expenses are deductible on a current basis even though some of these expenditures provide a benefit in the future.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 4.)*

Advertising expenses are deductible on a current basis even though some of these expenditures provide a benefit in the future. Under the benchmark tax system, the expenses would be amortized over the benefit period.

The estimates provided are based upon the assumption that 25 per cent of advertising costs incurred in a particular year provide a benefit in the following two years. Since tax expenditures are estimated on a cash-flow basis, an increase in annual advertising costs would result in a positive estimate of the tax expenditure. Decreases in annual advertising costs would result in a negative estimate of the tax expenditure.

Deductibility of Contributions to Mine Reclamation and Environmental Trusts

Objective: *Contributions to mine reclamation and environmental trusts have been made deductible in order to assist firms that are required to make such contributions. Prior to this change, the mandatory contributions, in combination with previous income tax rules, led to two problems for companies. First, they could give rise to cash-flow problems and second, some companies, particularly single-mine companies, may have been unable to fully utilize the deduction of actual reclamation expenses, since the majority of these expenses occur at the end of the life of the mine, when it no longer produces income.*

This measure also assists companies subject to environmental regulations to meet their obligations under the relevant federal or provincial statutes without distorting governments' choices of instrument used to provide assurance that adequate funds are available to conduct restoration activities at the end of operations. (Tax Measures: Supplementary Information, February 22, 1994. Budget Plan, February 18, 1997.)

Certain environmentally sensitive activities can disturb the natural environment in the area where the activity takes place, and measures may need to be taken to repair the environmental damage after operations have terminated. In these situations, governments may require companies to set aside funds in advance in trust funds to ensure that adequate amounts are available to conduct restoration activities at the end of operations.

The 1994 budget permitted a deduction of government-mandated contributions to mine reclamation trusts in the year in which they are made rather than permitting a deduction only when the mine reclamation costs are actually incurred. Income earned in such trusts is subject to tax each year under special Part XII.4 rules. The same income taxed in the trust is considered taxable income of the beneficiary, but the beneficiary also receives a refundable tax credit on its share of the tax paid by the trust. When actual reclamation costs are incurred, any withdrawal of funds from the trust will be included in income subject to tax and the actual reclamation costs incurred will be deductible. The 1997 budget extended this treatment to similar funds established for waste disposal sites and quarries for the extraction of aggregate and other similar substances.

The overall effect is to provide cash-flow assistance to companies as they set funds aside but to recover the income forgone plus interest when the actual reclamation work is done. The value of the tax expenditure over the life of the project is, therefore, nil. However, in any given year the value of the tax expenditure is the amount of tax relief that is effectively provided by allowing payments to be deducted from income when contributions are made to the trust. This tax expenditure could be positive or negative depending upon the amount of contributions to and withdrawals from these trusts in a particular year.

Deductibility of Countervailing and Anti-Dumping Duties

> ***Objective:*** *The deduction of these duties when paid, rather than waiting to deduct the exact amounts upon final resolution of the dispute, assists firms. This assistance recognizes that these firms are required to pay amounts that are not under the control of the taxpayer, and although these amounts may be subsequently refunded, in whole or in part, this process can take several years. (Budget Plan, February 24, 1998.)*

In accordance with the rules established under the World Trade Organization, countervailing and anti-dumping duties may be imposed by countries to offset the injurious effects of imports that are subsidized or dumped. These actions may result in Canadian taxpayers paying such amounts in order to export their products. The 1998 budget made cash outlays for duties deductible in computing income subject to tax in the year they are paid even though these amounts may be refunded, in whole or in part, in a subsequent year. Any refunds or additional amounts subsequently received, such as interest, would have to be included in income in the year of receipt.

The value of the tax expenditure is the amount of tax relief provided by allowing these contingent costs to be deducted from income when paid rather than when the exact amount, if any, of the duty is determined. This tax expenditure could be positive or negative depending upon the amount of countervailing duties paid and recovered by firms in a particular year.

No forecasts have been made of the future tax expenditure amounts since it is not possible to determine the cost of future trade actions affecting Canadian taxpayers.

Deductibility of Earthquake Reserves

> ***Objective:*** *In 1997, the Office of the Superintendent of Financial Institutions introduced new guidelines that require federally regulated insurance companies selling earthquake protection to meet target levels of preparedness to ensure they have sufficient financial capacity to pay insured earthquake losses when they occur. This measure helps to ensure that sufficient capacity is achieved in a timely fashion.*
> *(Budget Plan, February 24, 1998.)*

An earthquake reserve is composed of two parts: the first element, the "earthquake premium reserve," is based on a percentage of net earthquake premiums written; the second element, the "earthquake reserve complement," takes into account the earthquake exposure reinsured with another insurance company and a proportion of the capital and surplus of the company. The 1998 budget made the "earthquake premium reserve" deductible for income tax purposes. Under the benchmark system, such reserves would not be deductible.

Cash Basis Accounting

> ***Objective:*** *It would create some hardship to require farmers and fishers to adopt the accrual method because of the accounting and liquidity problems which this might involve for those with relatively small incomes. As a result, farming and fishing corporations are permitted to use the cash basis of accounting.*
> *(Report of the Royal Commission on Taxation, 1966, vol. 4.)*

Farming and fishing corporations may elect to include revenues as received, rather than when earned, and deduct expenses when paid rather than when the related revenue is reported. This treatment allows a deferral of income and a current deduction for prepaid expenses. Under the benchmark tax structure, income is taxable when it accrues and expenses are deductible in the period to which they relate.

No data are available.

Flexibility in Inventory Accounting

> ***Objective:*** *This measure ensures that farmers operating on a cash basis are able to avoid creating losses that would be subject to the time limitation if carried forward.*
> *(Budget Supplementary Information, 1973.)*

Farm corporations using the cash basis method of accounting are allowed to depart from it with regard to their inventory. A discretionary amount, not exceeding the fair market value of farm inventory on hand at year-end, may be added back to income each year. This amount must then be deducted from income in the following year. The effect of this provision is to allow farm corporations to avoid creating losses which, if carried forward, would be subject to the time limitation. Thus, the tax expenditure provides tax relief to the extent that the losses would otherwise have been subject to the time limitations.

No data are available.

Deferral of Income From Grain Sold Through Cash Purchase Tickets

> ***Objective:*** *By permitting the deferral of the reporting of income on grain sales, this measure facilitates the orderly delivery of grain to elevators, ensuring that Canada meets its grain export commitments. (Budget Papers, 1974.)*

Farmers may make deliveries of grain before the year-end and be paid with a ticket that may be cashed only in the following year. The payment for deliveries of grain is included in income only when the ticket is cashed, thereby providing a deferral of taxes. Under the benchmark tax system, income would be taxed on an accrual basis.

The estimates are based on data provided by the Canadian Wheat Board. Since tax expenditures are estimated on a cash-flow basis, an increase in the balance of uncashed grain tickets represents additional income that is being deferred and results in a positive estimate of the tax expenditure. A decrease in the balance of uncashed grain tickets indicates that less income is being deferred and results in a negative tax expenditure.

Deferral of Income From Destruction of Livestock

> ***Objective:*** *This deferral was introduced to allow farmers operating on a cash basis adequate time to replace their herds, destroyed under statutory authority, without imposing a tax burden in the year of livestock destruction. (Budget Papers, 1976.)*

If the taxpayer elects, when there has been a statutory forced destruction of livestock, the income received from the forced destruction can be deemed to be income in the following year. The deferral is also available when the herd has been reduced by at least 15 per cent in a drought year. This provision allows for a deferral of income to the following year when the livestock is replaced. Under the benchmark tax system, income is taxed on an accrual basis.

Deferral Through Use of Billed-Basis Accounting by Professionals

> ***Objective:*** *This treatment recognizes the inherent difficulty in valuing unbilled time and work in progress. (Summary of 1971 Tax Reform Legislation, 1971.)*

Under accrual accounting, costs must be matched with their associated revenues. In computing their income for tax purposes, however, professionals are allowed to elect either an accrual or a billed-basis accounting method. Under the latter method, the costs of work in progress can be written off as incurred even though the associated revenues are not brought into income until the bill is paid or becomes receivable. This treatment gives rise to a deferral of tax.

No data are available.

International

Non-Taxation of Life Insurance Companies' World Income

> ***Objective:*** *To ensure that life insurance companies can compete in foreign markets, foreign income is exempted from tax in Canada. Canadian insurers could not compete in other countries if Canada imposed the normal tax rules on profits earned in a country that taxes on the basis of premiums or investment revenue only. (Supplementary Budget Papers, March 31, 1977.)*

All Canadian corporations except Canadian multinational life insurers are taxed on their worldwide income. Canadian multinational life insurers are taxed only on their profits from carrying on a life insurance business in Canada using special rules in the income tax regulations.

Prior to 1993, the cost of this tax expenditure was estimated from tax returns and information available from the Office of the Superintendent of Financial Institutions. However, information required to estimate this tax expenditure is not available after 1992.

Exemptions From Non-Resident Withholding Tax

Objective: *Over time, as the benefits of freer trade in capital, goods and services have been increasingly recognized, countries including Canada have adjusted their tariff and tax structures to remove impediments to international transactions. Part of this adjustment has been the reduction in non-resident withholding tax on certain payments.*

Lower withholding taxes can reduce the cost to Canadian business of accessing capital and other business inputs from abroad. For example, a lower Canadian withholding tax on interest payments to non-residents can reduce the cost of accessing foreign capital in certain situations. Similarly, a reduced withholding tax on royalty payments can reduce the cost of accessing foreign technology and other property and services, and thereby enhance the competitiveness of Canadian businesses requiring these inputs.

Canada, like other countries, imposes a withholding tax on various types of income paid to non-residents. The basis for this tax rests on the internationally accepted principle that a country has the right to tax income that arises or has its source in that country. The types of income subject to non-resident withholding tax include: certain interest, dividends, rents, royalties and similar payments; management fees; estate and trust income, alimony and support payments; and certain pension, annuity and other payments.

Canada's statutory non-resident withholding tax rate is 25 per cent. However, the rate is lowered and exemptions are provided for certain payments through an extensive network of bilateral tax treaties. These rate reductions, which apply on a reciprocal basis, differ depending on the type of income and the tax treaty country.

The Income Tax Act also provides for a number of unilateral exemptions from withholding tax, including exemptions for the following: interest payments on government debt; interest payments to arm's-length persons on long-term corporate debt; interest payments to arm's-length persons on foreign currency deposits with branches of Schedule I banks; and royalty payments for the use of copyright.

The estimates of the tax expenditures associated with withholding tax exemptions for certain royalties, interest, dividends and management fees paid to non-residents were derived from a detailed analysis of payments to non-residents and withholding tax collections on those payments for 1992, 1993 and 1994, and projections of payments to non-residents over the post-1994 period. The cost estimates were derived by applying treaty withholding tax rates (in the case of payments to a country with which Canada had a tax treaty in the year considered) or the statutory 25-per-cent withholding tax rate (in the case of payments to non-treaty countries) that would otherwise apply, in the absence of an exemption, to observed and projected payments data under the benchmark assumption used throughout this publication of no behavioural response to the hypothetical removal of existing withholding tax exemptions.

This benchmark assumption of no behavioural response is particularly difficult to sustain for this type of tax. Foreign providers of capital, technology and other property and services, in most cases, are unwilling to bear the withholding tax given that they do not pay such a tax when supplying other markets. If a withholding tax was to be imposed, foreign providers would either require that the tax be shifted back to the Canadian borrower or user of property or services in the form of higher charges (which in many cases could not be absorbed), or they would bypass Canada in favour of other foreign

markets where such a tax does not exist, again implying increased financing and other business costs for Canadians. Indeed, these same competitiveness considerations have led to the introduction of a number of withholding tax exemptions both in Canada and in other countries.

Thus, these particular tax expenditure estimates cannot be interpreted as additional revenues that could be collected from non-residents if the withholding tax exemptions were removed, since the removal of the exemptions would generally involve the elimination of the tax base.

Exemption From Canadian Income Tax of Income Earned by Non-Residents From the Operation of a Ship or Aircraft in International Traffic

> ***Objective:*** *The international shipping tax exemption is a reciprocal tax exemption provided for income earned by a non-resident person in Canada from the operation of a ship or aircraft in international traffic. This exemption, whose purpose is the avoidance of international double taxation, was first introduced in the Income War Tax Act at a time when Canada had few bilateral double taxation agreements.*

Non-resident persons operating a ship in international traffic are exempted from Canadian income tax, as is done in other countries. Similarly, non-resident persons operating an airline in international traffic are exempted from Canadian income tax. In both cases, the exemption applies only if the non-resident's home country gives Canadian residents substantially similar tax relief. The amount of the tax expenditure is the tax that would otherwise be payable on profits related to the Canadian business of the non-resident persons, net of the tax collected on the non-Canadian income of the resident persons.

No data are available.

Other Items

Transfer of Income Tax Room to Provinces in Respect of Shared Programs

> ***Objective:*** *One percentage point of corporate tax is transferred to the provinces as part of the federal contribution under the Canada Health and Social Transfer. This transfer assists provinces in providing services in the areas of health, post-secondary education and social assistance.*

In 1967, federal-provincial fiscal arrangements were altered. The federal government substituted a transfer of corporate income tax points for direct transfers to provinces under the cost-shared program for post-secondary education. The tax change involved an increase in the corporate income tax abatement rate from 9 to 10 percentage points, effectively reducing the federal corporate income tax rate at that time from 37 per cent to 36 per cent (the rate before the abatement was 46 per cent). This transfer of tax room has been included as a tax expenditure because it is a substitute for direct spending programs.

Interest Credited to Life Insurance Policies

> ***Objective:*** *Not requiring the reporting of income of exempt policies on an accrual basis reduces complexity for policyholders and insurance companies.*

Life insurance companies are taxed under the investment income tax (IIT) at a rate of 15 per cent on net investment earnings attributable to life insurance policies.

The IIT interacts with the taxation of policyholders. The Income Tax Act divides life insurance policies into two categories: savings-oriented policies and protection-oriented policies.

Savings-oriented policies are those where the amount of money invested in the policy is large relative to the death benefit. A holder of a savings-oriented policy is subject to annual accrual taxation in respect of the net investment earnings credited to the policy. Net investment earnings reported by these holders are subtracted from the IIT base in order to avoid double taxation of net investment earnings.

In contrast, a holder of a protection-oriented policy is not subject to annual accrual taxation. Net investment earnings are taxed when the policy is sold or surrendered, terminated (other than by death), or when paid out as policy dividends once the cumulative dividends exceed the total premiums paid under the policy. Net investment earnings that are taxable to holders of protection-oriented policies are also deductible from the IIT base.

Most of the cost of the tax expenditure relates to protection-oriented policies. This cost has three basic elements:

- differences between personal and IIT rates;
- timing differences (i.e., policies that are eventually taxed in the hands of policyholders); and
- permanent differences (i.e., policies that are held until the death of the insured).

Non-Taxation of Registered Charities and Other Non-Profit Organizations

> ***Objective:*** *Charities play a useful and important role in our national life. They are significant in the fields of education, medicine, scientific research, culture, religion and athletics, to name just a few major areas. Their role is to fill in gaps of service and financial support where governments should not or cannot play a significant part. To support these charities, the Government exempts registered charities from income tax. (Discussion Paper: The Tax Treatment of Charities, June 23, 1975.)*

Registered charities and other non-profit organizations, both incorporated and unincorporated, are exempt from income tax. This is a tax preference to the extent that the charity or organization has taxable income, mainly investment income or profits from certain commercial activities.

No data are available.

Income Tax Exemption for Provincial and Municipal Corporations

> ***Objective:*** *The Constitution Act states that no lands or property belonging to Canada or any province shall be liable for taxation. This provision means that Crown corporations created at one level of government are exempt from paying taxes imposed by the other level of government, or by governments at the same level. This immunity from taxation extends to all agents of Canada or a province.*
> *(Section 125 of the Constitution Act.)*

Provincial Crown corporations and municipal corporations are exempt from income tax. Under the benchmark tax structure, such corporations would be taxable to the extent that they had taxable income.

No data are available.

Non-Taxation of Certain Federal Crown Corporations

> ***Objective:*** *Federal Crown corporations that carry on significant commercial activities are subject to federal income tax, which ensures that they compete on a level playing field with similar businesses in the private sector. Other federal Crown corporations are exempt from taxation. Their exempt status avoids the compliance and administration costs associated with filing an income tax return. Furthermore, the net financial position of the federal government would be unchanged if these Crown corporations were required to pay income taxes – the payment of taxes would merely be a transfer of funds from the Crown corporation to consolidated revenues.*

While federal Crown corporations are generally not subject to income tax, those Crown corporations that carry on significant commercial activities are taxable. It is possible, however, that some exempt corporations have income that would be taxable under the benchmark tax system.

No data are available.

Aviation Fuel Excise Tax Rebate

> ***Objective:*** *The aviation fuel excise tax rebate is designed to provide airlines with an immediate cash-flow benefit in exchange for a reduction in accumulated losses that would otherwise be available to reduce income taxes in future years.*

The aviation fuel excise tax rebate, which is effective for the calendar years 1997 to 2000 inclusive, provides excise tax rebates on the aviation fuel used by airline companies. Rebates are limited to $20 million per year per associated group of companies. In order to receive a rebate, a company must agree to reduce its income tax losses by 10 dollars for every 1 dollar of rebate.

Surtax on the Profits of Tobacco Manufacturers

> ***Objective:*** *The surtax on the profits of tobacco manufacturers is intended to maintain federal revenues in the tobacco sector.*
> *(Department of Finance Canada News Release 96-086, November 28, 1996.)*

Tobacco manufacturers are subject to a special surtax on their profits. The surtax is levied at a rate of 40 per cent of the Part I tax on tobacco manufacturing profits. The surtax was originally announced as part of the National Action Plan to Combat Smuggling in February 1994 for a three-year period, and was extended for another three years from February 1997. In November 1999, the Government announced that, effective February 2000, the surtax would be made permanent. The surtax is considered a tax expenditure because it constitutes a departure from the benchmark system. Because the surtax results in more revenues than would otherwise be raised under the benchmark tax system, it is a negative tax expenditure.

Resource Sector Tax Rate

> ***Objective:*** *Canada must ensure that its business income tax system is internationally competitive. The resource sector (crude oil, natural gas and mining) benefits from special deductions, such as the resource allowance when it exceeds royalties, accelerated exploration and development expenses and fast write-offs for certain capital assets, all of which serve to reduce its effective tax rate.*
> *(The Budget Plan 2000, February 28, 2000.)*

The 2000 budget proposed a 7-per-cent reduction in the general corporate income tax rate applicable to most businesses in Canada. The first proposed reduction will be from 29.12 per cent to 28.12 per cent for income that does not qualify for special tax treatment. Special tax treatment is provided to small businesses, manufacturing operations and the non-renewable natural resource sectors (i.e., oil and gas production and mining). The 2000 budget proposed that these latter sectors will continue to be subject to the 29.12 per cent rate (i.e., the statutory rate of 28 per cent plus the 4-per-cent surtax), given that they qualify for a number of special tax provisions that lower their taxable income base and therefore lower their effective tax rate. The Department has initiated consultations with resource industries associations and provinces to determine whether adjustments can be made to the existing resource tax structure so as to extend the proposed lower rates to the non-renewable natural resource sector.

In accordance with the definition of a standard benchmark, which has been set for 28.12 per cent in 2001, the higher tax rate of 29.12 per cent that will continue to apply to the resource sectors constitutes a negative tax expenditure (i.e., it results in more corporate income tax being paid than what would be the case if the benchmark tax rate were to be applied). This negative tax expenditure will offset a portion of the various positive tax expenditures available only to these sectors (i.e., the resource allowance when it exceeds royalties, accelerated exploration and development expenses and fast write-offs for certain capital assets).

The negative tax expenditure set out in the document for 2001 and 2002 is calculated as the extra federal corporate income tax payable by the sectors because of the introduction of the 1-per-cent lower general rate effective January 1, 2001.

Temporary Tax on the Capital of Large Deposit-Taking Institutions

> ***Objective:*** *The temporary tax on the capital of large deposit-taking institutions was adopted to help achieve deficit reduction targets. (Budget Plan, February 27, 1995.)*

The temporary surcharge is levied at a rate of 12 per cent of the financial institution capital tax imposed under Part VI of the Income Tax Act calculated before any credit for income taxes and as if there was a capital deduction of $400 million. The surcharge applies to financial institutions as defined under Part VI, but not to life insurance companies. The surcharge is not eligible to be offset by tax payable under Part I.

The surcharge was introduced in the 1995 budget for a period of 18 months and extended for one year in the 1996, 1997, 1998 and 1999 budgets. The 2000 budget proposed to extend the surcharge to October 31, 2001, pending completion of the review of the application of this surcharge as announced by the Government in its June 25, 1999, paper *Reforming Canada's Financial Services Sector: A Framework for the Future.*

The surcharge is considered a tax expenditure because it constitutes a departure from the benchmark system. Because the surcharge results in more revenues than would otherwise be raised under the benchmark tax system, it represents a negative tax expenditure.

Memorandum Items

Refundable Taxes on Investment Income of Private Corporations

> ***Objective:*** *A refundable Part I tax levied on the investment income of private corporations is intended to reduce the deferral advantage to individuals of earning investment income through these private corporations instead of earning such income directly. The deferral advantage arises when the corporate tax rate applied to this income is lower than the marginal tax rate of the individual shareholder. (Budget Plan, February 27, 1995.)*

Refundable tax provisions of the corporate income tax system provide some integration of the corporate and personal income tax regimes. These provisions include:

- a refundable tax (Part IV tax) of $33^1/_3$ per cent on intercorporate dividends received by private corporations (25 per cent on dividends received prior to July 1, 1995); and
- an additional Part I tax of $6^2/_3$ per cent on the investment income (excluding deductible intercorporate dividends) received after June 30, 1995, by Canadian-controlled private corporations (CCPCs).

These additional taxes, as well as 20 percentage points of the Part I tax paid by CCPCs on investment income (excluding deductible intercorporate dividends), are refundable to the corporation at a rate of one dollar for every three dollars of taxable dividends paid (prior to July 1, 1995, the refund was one dollar for every four dollars of taxable dividends paid).

The additional Part I tax on the investment income of CCPCs, the Part IV tax on intercorporate dividends and the amount of refundable taxes refunded upon the payment of dividends are considered to be tax expenditures because they constitute a departure from the benchmark system. In addition, because investment income of CCPCs is subject

to Part I tax at a rate of 29.12 per cent rather than at the benchmark rate, this additional tax also represents a departure from the benchmark system and is included as part of the "Additional Part I taxes." Because the additional Part I taxes and the Part IV tax result in more revenues than would otherwise be raised under the benchmark system, they are negative expenditures. To the extent that, in a particular year, the amount of refundable taxes refunded upon the payment of dividends exceeds the total of the additional Part I tax on the investment income of CCPCs and the Part IV tax on intercorporate dividends, there is a net tax expenditure.

Refundable Capital Gains for Investment Corporations and Mutual Fund Corporations

Objective: *This item is part of an integrated system of measures that ensures that the treatment of capital gains earned by investment corporations or mutual fund corporations and subsequently distributed is generally comparable to the treatment of capital gains earned directly by an individual. The rationale for this integrated system is that investments made through these kinds of corporations are comparable to investments made by an individual since these special investment corporations must hold only passive investments.*

Capital gains realized by an investment corporation and a mutual fund corporation are taxed at the corporation level, and the tax is accumulated in the "refundable capital gains tax on hand" account. The corporation uses this account to claim a capital gains refund when it distributes capital gains dividends to its shareholders or through share redemptions by a mutual fund corporation. Since these dividends are capital gains distributions, they are taxed as capital gains in the hands of the shareholder and not as dividends.

This measure is considered a tax expenditure because it constitutes a departure from the benchmark system by allowing a public corporation (that qualifies as an investment corporation or a mutual fund corporation) to flow out its capital gains to shareholders. The result is that the distributed capital gains will be taxed at the same rate as if the corporation were a private corporation.

Loss Carry-overs

Objective: *Loss carry-overs are provided to support business operations and investment in a number of ways. Permitting the carry-over of losses provides certainty to firms that they can benefit from tax losses sustained and that they can obtain immediate tax relief by deducting losses against prior years' income, thus reducing the risks faced by investors. (Budget Papers: Supplementary Information and Notice of Ways and Means Motions on the Budget, April 19, 1983.)*

The cyclical nature of business and investment income suggests that the impact of such income should be viewed over a longer period of time rather than on an annual basis. As a result, carry-overs of losses are treated as part of the benchmark tax system. The loss carry-over rules permit taxpayers to apply their losses against past or future income. The estimates provided indicate approximately how much tax revenue the Government forgoes by allowing current-year losses to be carried back (i.e., applied to reduce tax paid in previous years) and by allowing losses of previous years to be carried forward and

applied to reduce tax otherwise payable for the current year. There are four types of losses that can be carried over, and specific provisions apply to each.

Non-Capital Losses

A non-capital loss is a company's loss from business operations. Non-capital losses may be carried back three years and forward seven years to reduce or offset the corporation's taxable income.

Estimates reflecting the impact of the carry-forward of prior years' losses (i.e., non-capital losses applied to the current year) include the revenue impact of allowing non-capital losses of previous years to be applied to reduce Part I tax and the refundable Part IV tax otherwise payable for the current year. Estimates reflecting the impact of allowing current-year losses to be applied to reduce income tax paid in previous years (i.e., non-capital losses carried back) include the impact on both Part I tax and refundable Part IV tax.

Net Capital Losses

A net capital loss can arise from the disposition of capital property. This type of loss may be carried back three years and forward indefinitely but can only be applied against net taxable capital gains.

Estimates are provided for both the revenue impact of allowing net capital losses of previous years to be applied to reduce income tax otherwise payable for the current year (i.e., net capital losses applied to the current year) and the impact of allowing current-year net capital losses to be applied to reduce income tax paid in previous years (i.e., net capital losses carried back).

Farm Losses and Restricted Farm Losses

A corporation can deduct, in the calculation of net income, a loss incurred from a farming or fishing business. The unused losses of this business may be carried back 3 years and forward 10 years.

When the corporation's major source of income is not farming, the amount of farming losses deductible in the year is restricted to a maximum of $8,750. The unused losses, defined as the excess of the net farm losses over the farm losses deductible in the year, are considered restricted farm losses. Restricted farm losses may also be carried back 3 years and forward 10 years but can only be applied against farm income.

Estimates consist primarily of the revenue impact of allowing farming losses of previous years to be applied to reduce income tax otherwise payable for the current year.

The revenue impact of applying restricted farm losses is minimal.

Deduction of Meals and Entertainment Expenses

> ***Objective:*** *To reflect the existence of the personal consumption element of meal and entertainment expenses, only 50 per cent of these costs are deductible (80 per cent before March 1, 1994).*
> *(Income Tax Reform, June 18, 1987; Budget Papers, 1994.)*

Meals and entertainment expenses are considered to be a memorandum item because the amount that should be deductible under a benchmark tax system is debatable. While a portion of these expenditures is incurred in order to earn income, there is an element of personal consumption associated with these expenditures. Consequently, only a partial deduction for these expenses would be permitted under the benchmark tax system.

Generally, the deduction is limited to 50 per cent of the cost of food, beverages and entertainment (80 per cent before March 1, 1994) in order to reflect the personal consumption portion of these costs. The estimates provided reflect the additional tax revenue that would be received if no deduction were allowed (i.e., that there is no business purpose to the expenditure).

Large Corporations Tax

> ***Objective:*** *This tax ensures that all large corporations, and groups of related corporations, with more than $10 million of taxable capital employed in Canada pay some federal tax. (Budget Papers, April 27, 1989.)*

The large corporations tax (LCT) was introduced on July 1, 1989, as a tax on the Canadian capital of large corporations. The rate of tax in 1993 and 1994 was 0.2 per cent. The 1995 budget increased the LCT rate to 0.225 per cent effective budget day 1995.

Companies can reduce their LCT liability to the extent of the Canadian portion of their corporate surtax. The rate of corporate surtax was increased from 3 per cent to 4 per cent in the 1995 budget.

Threshold

> ***Objective:*** *The objective of the LCT threshold is to ensure that smaller businesses will not be subject to the tax. (Budget Papers, April 27, 1989.)*

The $10-million capital deduction effectively exempts smaller corporations from the LCT as long as these corporations are not related to other corporations subject to the LCT – that is, the $10-million deduction must be shared among related corporations. This capital deduction is not considered to be a tax expenditure because it is generally available to all corporations.

Exempt Corporations

> ***Objective:*** *Because the corporate surtax is creditable against the LCT liability, corporations are effectively subject to the greater of the LCT and the corporate surtax. If corporations exempt from paying Part I tax and its related corporate surtax were subject to the LCT, they would have no way of reducing the LCT. As a result, certain corporations such as non-resident investment corporations, deposit insurance corporations and corporations exempt from paying Part I income tax are also exempted from paying the LCT.*

Certain corporations such as non-resident investment corporations, deposit insurance corporations and corporations exempt from paying Part I income tax are exempt from paying the LCT. This exemption is a tax expenditure, but data are not available to estimate its value.

Patronage Dividend Deduction

> ***Objective:*** *The purpose of this tax expenditure is to place co-operatives in a position of tax equality with other forms of business enterprise considering that obligated patronage dividend payments reduce the ability to pay tax. To avoid discrimination, similar treatment is provided for patronage dividends distributed by ordinary companies, partnerships or individual business enterprises. (Budget Speech, 1946.)*

In computing income for a taxation year, a taxpayer is allowed to deduct patronage dividend payments made to customers. Patronage dividends are payments made to customers in proportion to their volume of business. The taxpayer is required to withhold 15 per cent of all patronage dividends in excess of $100 paid to each customer who is resident in Canada.

The appropriate benchmark tax treatment of patronage dividends is uncertain. These dividends could be considered to be analogous to the payment of a volume discount or the return of excess payments. With this view of the benchmark system, this would not be a tax expenditure.

Alternatively, these payments could be perceived as the distribution to members (or shareholders) of earnings that would not be deductible under the benchmark system. The amount shown, reflecting this view of the benchmark system, is the revenue impact of allowing patronage dividends to be deductible from income.

Logging Tax Credit

> ***Objective:*** *The logging tax credit was introduced as a means of relieving the tax burden on the forest industry. (Budget Speech, April 10, 1962.)*

The logging tax credit reduces federal taxes payable by the lesser of two-thirds of any logging tax paid to a province and $6^2/_3$ per cent of income from logging operations in that province. This reduction in federal taxes can be argued to be a tax expenditure for the reasons similar to those discussed with reference to the resource allowance deduction.

Deductibility of Provincial Royalties (Joint Venture Payments) for the Syncrude Project (Remission Order)

Objective: *The Syncrude project was initiated in the early 1970s when all provincial Crown royalty charges were fully deductible in the computation of income taxes. After a joint venture agreement with the province of Alberta was signed, the project participants received assurances from the federal government that the joint venture payments to the province would be treated as royalties.*

In May 1976, the Government granted a remission order to Syncrude participants by Order in Council. The remission order permits participants to deduct joint venture payments to the province of Alberta. Income tax regulations provide a resource allowance on the net amount when calculating federal corporate income taxes.

The remission order provides for the deduction of joint venture payments for production from Leases 17 and 22 until the earlier of December 31, 2003, or when cumulative production reaches 2.1 billion barrels.

Taxpaying participants in the Syncrude project are permitted to deduct both a resource allowance and "joint venture payments" made to the province of Alberta in lieu of a royalty in computing income subject to tax. This is accomplished through a remission order. Under the benchmark tax system, these joint venture payments, which are profit sensitive, would not be deductible.

Deductibility of Royalties Paid to Indian Bands

Objective: *Royalties paid to Indian bands were deductible prior to the 1974 budget. The Government allowed these royalties to continue to be deductible after 1974 to encourage further development of non-renewable natural resources on Indian lands.*

Royalties and lease rentals paid to Indian bands in respect of oil and gas and mining activities on Indian reservations are paid to Her Majesty in Right of Canada in trust for the Indian band. Unlike non-deductible Crown charges, amounts paid to the benefit of an Indian band are generally deductible for federal income tax purposes. In addition to the deductible Crown charges, a resource allowance is earned on the resource profits net of the deductible Crown charges.

The amounts paid to the Government of Canada in the form of mining and oil and gas royalties/lease rentals paid to Indian bands are provided below:

Oil and Gas and Mining Royalties/Lease Rentals Paid to Indian Bands

	1995-96	1996-97	1997-98	1998-99
			($ millions)	
Oil and gas	58.0	92.0	89.0	99.0
Mining	0.5	1.0	2.0	0.9

Source: Indian and Northern Affairs Canada.

Non-Resident-Owned Investment Corporation Refund

> ***Objective:** The general rationale for the refund provided to non-resident-owned investment corporations is to encourage the investment of foreign funds in Canadian corporations at little tax cost to the Government.*
> *(Report of the Royal Commission on Taxation, vol. 4, 1966.)*

A non-resident-owned investment corporation must pay income tax at a rate of 25 per cent. However, except for capital gains realized on taxable Canadian property, this tax is refundable when the surplus is distributed as taxable dividends to the shareholders, and the applicable rate of withholding tax then applies. As a result, the corporation is essentially treated as a conduit for the flow-through of income to the non-resident shareholders. The amounts reported estimate the tax revenues that would be generated if the non-resident-owned investment corporation refund was not available, under the no-behavioural assumption used throughout this publication.

The 2000 budget proposed to eliminate the status of non-resident-owned investment corporations. Unlike the estimates presented in the present publication, the budget estimates take into account the behavioural considerations of the proposed policy.

Investment Corporation Deduction

> ***Objective:** Investment corporations provide an important flow of individual savings available for investment in the ownership of Canadian industry because qualifying investment corporations must invest in Canadian properties. The purpose of this measure is to induce investment of these savings in Canada rather than abroad.*
> *(Budget Speech, December 20, 1960.)*

Investment income is taxed at the corporation level and in the hands of the individual who receives it as dividend payments. In order to achieve a certain degree of integration between the personal and corporate tax systems, the current rules allow an investment corporation to deduct from its Part I tax otherwise payable 20 per cent of the amount by which its taxable income exceeds its taxed capital gains.

This measure constitutes a tax expenditure because it allows a public corporation that qualifies as an investment corporation to benefit from elements of the integration system, which are usually available only to private corporations. The tax expenditure is estimated as the additional revenue that would have been collected by the Government if investment income (except capital gains) had been taxed at the general income tax rate applicable to public corporations. In addition, because investment corporations are subject to Part I tax at a rate of 29.12 per cent rather than at the benchmark rate, this additional tax represents a departure from the benchmark system and is included as part of this expenditure.

Deferral Through Capital Gains Rollovers

> ***Objective:*** *Rollover provisions are provided in some situations in which it would be unfair to collect a capital gains tax even though the taxpayer has sold or otherwise disposed of an asset at a profit. (Proposals for Tax Reform, 1969.)*

The taxation of capital gains is affected by provisions that permit taxpayers to defer realization for tax purposes through various rollover provisions. Since the benchmark tax structure includes various rollover provisions that permit the deferral of capital gains when a corporate structure is changed, this item is identified separately for information purposes.

No data are available.

Deduction for Intangible Assets

> ***Objective:*** *Three-quarters of eligible capital expenditures can be written off at 7 per cent per annum on a declining-balance basis. Prior to 1972, taxpayers could not deduct such expenditures on intangible assets in the year incurred (because they were capital in nature) or over a number of years by way of depreciation (because no asset was acquired on which depreciation could be claimed).*
> *(Summary of 1971 Tax Reform Legislation.)*

Three-quarters of eligible capital expenditures on intangible assets are added to the cumulative eligible capital of a taxpayer. A deduction of up to 7 per cent of cumulative eligible capital at the end of the year is allowed. Examples of intangible assets include goodwill, customer lists and franchises.

The deduction for intangible assets could give rise to positive or negative tax expenditure estimates depending on the actual rate of depreciation of these assets relative to the amount that is permitted for tax purposes.

No data are available.

Tax Exemption on Income of Foreign Affiliates of Canadian Corporations

> ***Objective:*** *The Canadian exemption system for taxing the income of foreign affiliates is based on the objective of eliminating double taxation while at the same time encouraging the international competitiveness of Canadian multinationals.*

The Canadian system for taxing the income of foreign affiliates of Canadian shareholders or the dividend income of the Canadian shareholders derived from foreign affiliates is based on the objectives of encouraging international competitiveness, protecting the tax base and eliminating double taxation.

Where the foreign affiliate earns active business income, Canada defers any recognition of that income until it is paid to the Canadian shareholders as a dividend on shares of the affiliate. In cases where the business income has been earned in a country with which Canada has a double taxation treaty, the dividend paid out of that income to Canadian

corporate shareholders is not subject to additional Canadian tax. Where the business income is earned in non-treaty countries, the dividend is taxed in Canada but a tax deduction is provided to Canadian corporate shareholders based on the underlying foreign tax paid.

Where the foreign affiliate earns passive income and the affiliate is a controlled foreign affiliate of a person resident in Canada, the passive income is taxed in the Canadian shareholder's hands on an accrual basis. The Canadian shareholder can deduct taxes paid in the foreign jurisdiction in determining net additional Canadian tax liability. When the income earned in the foreign affiliate is actually paid to the shareholder in the form of a dividend, a deduction from income subject to tax is provided to the extent that the income was included in income subject to tax in a previous year.

Questions arise as to what should be the appropriate benchmark system to measure the value of the tax expenditure, if any, in this case. Basically, three different benchmarks could be contemplated:

- **Canada should tax only Canadian-source income.**
  This is the territorial approach. Under this approach, foreign subsidiaries of Canadian companies would face the same tax burden on foreign-sourced business income as locally owned enterprises in the foreign jurisdiction. This approach is consistent with the concept of capital-import neutrality. Capital-import neutrality results when the shareholders of subsidiaries do not face additional taxes in Canada with respect to the foreign business income earned by their subsidiaries. This is the effect of Canada's decision not to tax dividends arising from affiliates in countries with which Canada has entered into a double taxation agreement as a way to relieve double taxation.
  If this exempt dividend approach were to be considered as the benchmark, then no preference would be associated with the foreign dividend exemption.
- Income earned by a foreign affiliate should be taxable in Canada when dividends are paid to the Canadian shareholder and double taxation alleviated with a foreign tax credit. This is the approach used by a number of countries since it allows for additional taxes to be collected in the country of residence of the shareholder of a foreign affiliate at the time a dividend is paid to the shareholder by the affiliate out of foreign business income. These additional taxes would be levied when domestic tax payable exceeds the amount of foreign taxes paid both on the dividend itself and on the underlying foreign corporate profits out of which the dividend was paid.
  In Canada, dividends from foreign affiliates that do not qualify as exempt dividends are taxed on this basis. If this were to be considered the benchmark system, then the exempt dividend system would provide a preference measured as the additional tax, net of the foreign tax credit, that would have been payable had the dividend been taxable in Canada.

- Income earned by foreign affiliates should be taxable in Canada as it accrues to the Canadian shareholder (i.e., on a current basis). This system is consistent with the concept of capital-export neutrality, which states that income of foreign affiliates should be subject to the same tax in the hands of its shareholders on a current basis regardless of whether the income is earned domestically or in a foreign affiliate. Certain passive income earned by controlled foreign affiliates is taxable on this basis in Canada. If this system was to be viewed as the benchmark, both the exempt dividend and the foreign tax credit approaches would be said to provide a preference measured as the deferral of incremental Canadian tax from the time the income is earned until the time the dividend is paid out.

Each of these three possible benchmarks has a policy justification. Data required to compute the amount of tax preference associated with any of the benchmarks are currently unavailable.

Chapter 4

Description of Goods and Services Tax/ Harmonized Sales Tax Provisions

Since the Goods and Services Tax/Harmonized Sales Tax (GST/HST) is levied at all points in the production and distribution chain, the value-added nature of the tax makes it equivalent to a retail sales tax levied on the sale of goods and services to the final consumer. Based on this equivalency, the GST/HST base can be estimated from a Sales Tax Model constructed using data obtained from Statistics Canada's Input-Output Tables and the National Income and Expenditure Accounts.

The data from the Input-Output Tables are used to derive detailed expenditures by commodity for households, public sector bodies and exempt businesses. The personal expenditure categories of the Input-Output Tables, along with the investment categories for residential construction, are used to derive commodity expenditures for households. The commodity expenditures of public sector bodies are derived from current government expenditure categories, in conjunction with relevant data obtained from the use matrix and appropriate investment categories contained in the Input-Output Tables. (Public sector bodies include the federal government, provincial governments, municipalities, universities, school boards, public colleges, public hospitals, charities and non-profit organizations.) The commodity expenditures of exempt businesses are derived from the input matrix of the Input-Output Tables in conjunction with data obtained from the appropriate investment categories.

The commodity data described above are used to identify the impact of the GST/HST provisions that either zero-rate or exempt certain goods and services. In some cases, modifications had to be made to the data derived from the Input-Output Tables and the National Income and Expenditure Accounts to account for the structure of the GST/HST. Since final Input-Output Tables for a given year are available only three years after the fact, National Income and Expenditure Accounts data are used to project the impact of each GST/HST provision to the relevant historical year. Expenditure data contained in the Department of Finance's Canadian Economic and Fiscal Model (CEFM) are used to project the impact of most of the GST/HST provisions over the forecast period.

It should be noted that the Sales Tax Model has been significantly revamped and is now based on Statistics Canada's historically revised 1996 national Input-Output Tables and the latest National Income and Expenditure Accounts. Previous estimates of tax expenditures were based upon 1990 Input-Output Tables released prior to Statistics Canada's historical revision. The historically revised structure of the National Accounts provides a superior framework for the derivation of tax expenditure estimates because of the additional level of detail.

Certain tax expenditure estimates have been significantly revised as a result of the latest model update. These revisions can be attributed to changes in the mix of commodities within expenditure categories as well as enhancements in the level of detail of the data found in the input-output structure.

The Sales Tax Model is not the sole source of the estimated tax expenditures associated with the GST/HST. In some cases, actual data from the Canada Customs and Revenue Agency (CCRA) were used for the tax expenditure estimates. In other cases, estimates were derived from entirely different sources. This chapter describes the various GST/HST expenditure estimates and how they were derived.

It should be noted that public sector body rebates are now being measured on an activity basis rather than on an entity basis. On an entity basis, if a hospital, for example, claimed a charity rebate as well as a hospital rebate the entire amount would have been recorded as a hospital rebate. On an activity basis, the rebates are recorded based on the activity regardless of the institution that claimed them. This change does not affect the total cost of public sector body rebates but results in a small reallocation among the rebate categories.

Zero-Rated Goods and Services

Basic Groceries

Objective: *The zero-rating of basic groceries reflects the widely held view of Canadians that, as a general principle, basic foodstuffs should not be taxed. (Goods and Services Tax Technical Paper, August 1989.)*

Basic groceries, which include the majority of foodstuffs for preparation and consumption at home, are zero-rated under the GST/HST. However, the tax is charged on certain goods such as soft drinks, candies and confections, and alcoholic beverages.

The cost of the tax expenditure can be estimated using the Sales Tax Model by identifying commodities purchased by final consumers and public sector bodies that are currently not subject to tax.

Prescription Drugs

Objective: *Drugs that are prescribed by a physician or dentist are zero-rated. As with basic groceries, this tax treatment is intended to ensure that prescription drugs remain free of tax. (Goods and Services Tax Technical Paper, August 1989.)*

Drugs that are controlled substances for which a prescription is required are zero-rated. This provision also includes other drugs that have been prescribed by a recognized health care practitioner. The associated dispensing fee is also zero-rated. However, this provision excludes those items labelled or supplied for veterinary use.

The estimate is derived using the Sales Tax Model.

Medical Devices

Objective: *A broad range of medical devices that are required to treat or cope with a chronic disease or illness or a physical disability are zero-rated. This is intended to ensure that these medical devices remain free of tax.*
(Goods and Services Tax Technical Paper, August 1989.)

A wide range of medical devices are zero-rated under the GST/HST. This includes canes, crutches, wheelchairs, medical and surgical prostheses, ileostomy and colostomy devices, artificial breathing apparatus, hearing and speaking aids, prescription eyeglasses and contact lenses, various diabetic supplies, and selected devices for the blind and for the hearing or speech impaired. In some instances, a device qualifies for tax-free status only if prescribed by a recognized health care practitioner.

The estimate is obtained using the Sales Tax Model.

Agricultural and Fish Products and Purchases

Objective: *Many agricultural and fish products are for human consumption and are therefore zero-rated as basic groceries. In addition, a large range of generally high-cost agricultural and fishing equipment is zero-rated to reduce cash-flow problems for farmers and fishers. (Goods and Services Tax Technical Paper, December 1989.)*

Instead of taxing sales and providing input tax credits at early stages in the food production-distribution chain, certain agricultural and fish products are zero-rated all through the chain. A prescribed list of such supplies includes farm livestock, poultry, bees, grains and seeds for planting or feed, hops, barley, flax seed, straw, sugar cane or beets. In addition, prescribed sales and purchases of major types of agricultural and fishing equipment are zero-rated.

The main effect of this provision is on the cash-flow position of taxpayers. For example, in the normal operation of the GST/HST, farmers would pay the GST/HST on taxable purchases and would claim a corresponding input tax credit at the end of their tax period. However, in the case of prescribed zero-rated supplies, the farmer does not pay the GST/HST and so does not have to wait to claim an input tax credit. Consequently, the cash-flow position of the farmer is improved. At the same time, however, the suppliers lose the benefit of holding the GST/HST on these purchases until the end of their tax period. Since the aggregate tax liability of these taxpayers remains unchanged, the revenue implications of this measure are small.

Certain Zero-Rated Purchases Made by Exporters

Objective: *Exports are destined for consumption outside Canada and, consequently, are not subject to GST/HST, which is a tax on consumption in Canada. The zero-rating provisions for exports are designed to ensure that goods and services acquired in Canada for export are totally relieved of tax.*
(Goods and Services Tax Technical Paper, August 1989.)

Certain supplies of goods and services delivered in Canada but subsequently exported are zero-rated. These include:

- the supply of goods to Export Distribution Centres (proposed for January 1, 2001);

- the supply of goods to a recipient who intends to export them, provided they are not excisable goods (spirits, beer or tobacco) and the goods are not further processed or modified in Canada by the recipient;
- the supply of excisable goods to a recipient who, in turn, exports the goods in bond;
- supplies of natural gas made to a person who is exporting the gas by pipeline and not further processing or using the gas in Canada before its exportation other than as fuel or compressor gas to transport the gas; and
- goods sold to duty-free shops licensed as such under the Customs Act.

As with agricultural and fish products, this provision has only cash-flow implications. Again, the impact of this measure on tax revenues is small.

Non-Taxable Importations

> ***Objective:*** *Goods imported into Canada are generally taxable. However, the legislation enumerates a short list of goods of different classes – such as basic groceries and prescription drugs – that, upon importation, do not attract the GST/HST. This ensures that imports are treated fairly vis-à-vis domestic-sourced goods that are zero-rated. (News Release, September 4, 1990.)*

Certain importations are tax-free under the GST/HST. These importations include:

- goods imported by Export Distribution Centres (proposed for January 1, 2001);
- goods, other than books and periodicals, valued at not more than $20 and mailed to residents of Canada from other countries;
- duty-free personal importations such as goods valued at not more than $750 and imported by Canadians who have been outside the country for more than seven days (the limit was $500 prior to July 1999); and
- goods imported by foreign diplomats.

No data are available.

Zero-Rated Financial Services

> ***Objective:*** *Financial services provided to non-residents for use outside Canada are zero-rated, consistent with the tax treatment of other exports. This ensures that Canadian institutions providing financial services remain competitive in global markets. (Goods and Services Tax Technical Paper, August 1989.)*

Financial services provided to non-residents are generally zero-rated. However, there are certain exceptions (e.g., financial services that relate to debt arising from deposits in Canada, real property situated in Canada, goods purchased for use primarily in Canada, services performed primarily in Canada).

The zero-rating provisions enable Canadian financial institutions that generate significant amounts of revenue through international activities to remain competitive in global markets.

No data are available.

Tax-Exempt Goods and Services

Residential Rent

Objective: *The objective of the housing rebates and exemptions for used homes and residential rents is to preserve the affordability of housing while ensuring that the tax regime is not overly complex. (Goods and Services Tax Technical Paper, August 1989).*

Rentals of a residential complex (such as a house) or a residential unit (such as an apartment) for a period of at least a month are tax-exempt. Short-term accommodation is also exempt where the charge for the accommodation is not more than $20 per day.

The estimate is derived using the Sales Tax Model.

Health Care Services

Objective: *Basic health care services are generally exempt of GST/HST. (Goods and Services Tax Technical Paper, August 1989.)*

Health care services are exempt under the GST/HST. These services include the following categories:

- institutional health care services provided in a health care facility. These include accommodation, meals provided with accommodation, and rentals of medical equipment to patients or residents of the facility. However, it excludes meals served in a cafeteria, parking charges, or haircuts for which a separate fee is charged;
- services provided by certain health care practitioners whose profession is regulated by the governments of at least five provinces. This category includes nursing, dental, optometric, chiropractic, physiotherapy, occupational therapy, speech therapy, chiropodic, podiatric, osteopathic, audiological and psychological services; and
- services covered by a provincial health insurance plan. Most of these services are already covered by the previous two provisions.

All exempt services that are covered by provincial health insurance plans are included in the benchmark because, under the Constitution, the GST/HST does not apply to purchases made by provincial governments. Thus, the only cost from this provision involves health services purchased by final consumers.

The estimates for this provision are derived from the Sales Tax Model.

Education Services (Tuition)

Objective: *Basic education is generally exempt of GST/HST. (Goods and Services Tax Technical Paper, August 1989.)*

The GST/HST provides an exemption for most educational services. The exemption includes tuition fees paid for courses provided primarily for elementary or secondary school students; courses leading to credits towards a diploma or degree awarded by a recognized school authority, university or college; and certain other types of training for a trade or vocation. In addition, the exemption covers meals supplied to elementary or secondary students as well as most meal plans at a university or college.

The estimate is derived from the revenues that would be collected if tuition fees were taxed and input tax credits were allowed for taxable purchases. The estimate takes into account the fact that universities and public colleges currently receive a rebate of 67 per cent of the tax that they pay on their purchases.

The estimate is derived from the Sales Tax Model.

Child Care and Personal Services

> ***Objective:*** *Under the GST/HST, no tax is charged on eligible child and personal care services provided to individuals who are underprivileged or suffer from an infirmity or disability. (Goods and Services Tax Technical Paper, August 1989.)*

Certain child and personal care services are exempt under the GST/HST. The exemption covers the following:

- child care services provided for periods of less than 24 hours to children under 14 years of age; and
- certain personal care services including supplies of care and supervision to residents of an institution, as well as accommodation where it is provided for children or disabled or underprivileged persons.

The estimate is derived using the Sales Tax Model. The estimate reported here does not account for day care that might be paid by governments, or day care provided by a non-profit organization. However, the impact of these exclusions on the overall estimate is unclear since provincial expenditures would not be subject to tax and the remaining expenditures would be eligible for partial rebates if taxed.

Legal Aid Services

> ***Objective:*** *Sales tax did not apply to legal aid services provided to a province's legal aid society under the former federal sales tax (FST). Under the GST/HST, a province's legal aid society is permitted to elect to treat contracts with private lawyers as taxable. This ensures that legal aid societies are able to obtain the same net benefit that existed under the former FST. (Goods and Services Tax Technical Paper, December 1989.)*

Legal services provided under a provincially authorized legal aid program are exempt under the GST/HST. This includes payments by the client in respect of the legal aid services and payments by a legal aid society to a private lawyer for legal services.

There are two ways in which the tax is relieved:

- legal aid services delivered directly by the Crown or a Crown agency (as is the case in Nova Scotia, Newfoundland, Prince Edward Island, Quebec, Manitoba and Saskatchewan) are exempt; and
- legal aid services provided by private practitioners to a legal aid plan administrator are taxable. However, the person responsible for the legal aid plan is entitled to a rebate of 100 per cent of any tax paid on the supply.

The CCRA supplied the data related to the rebates provided to legal aid plans in the provinces of New Brunswick, Ontario, Alberta and British Columbia. To account for the other provinces where the service is explicitly exempt, provincial economic accounts data are used. Specifically, it is assumed that the value of legal aid services relative to the total expenditures contained in the provincial economic account category "Personal Business" in the tax-exempt provinces would be the same as in those provinces where a rebate is provided.

The projected expenditure estimate is based on the growth in consumption obtained from the CEFM.

Ferry, Road and Bridge Tolls

> ***Objective:*** *Ferry, road and bridge tolls are generally exempt of GST/HST. This is consistent with the fact that the use of Canada's highway systems and related infrastructure is not subject to tax.*
> *(Goods and Services Tax Technical Paper, August 1989.)*

International ferry services are treated as zero-rated like other international transportation services. Other ferry, road and bridge tolls are GST/HST-exempt.

The estimate is derived using the Sales Tax Model.

Municipal Transit

> ***Objective:*** *Consistent with the treatment of standard municipal services, municipal transit services provided on a not-for-profit basis are exempt. Specifically, no tax applies on fares charged by transit systems operated by, on behalf of, a local authority or provincial government where all, substantially all, of its service is to provide transportation within a municipality and surrounding areas.*
> *(Goods and Services Tax Technical Paper, August 1989.)*

A municipal transit service is defined as a public passenger transportation service provided by a transit authority whose services are at least 90 per cent within a particular municipality and its surrounding areas. These municipal transit services are exempt under the GST/HST.

The estimate is derived using the Sales Tax Model.

Exemption for Small Businesses

> ***Objective:*** *Small suppliers, that is, persons whose total taxable supplies in the preceding year are $30,000 or less ($50,000 or less in the case of public sector bodies), are not required to register. Those who choose not to register do not have to charge and remit GST/HST, and they are not entitled to input tax credits. The objective of the small suppliers' threshold is to ensure that very small businesses do not face an excessive administration burden under the GST/HST.*
> *(Goods and Services Tax Technical Paper, August 1989.)*

Businesses or individuals with annual revenues of $30,000 or less from taxable and zero-rated transactions may elect to be exempt under the GST/HST. Such firms would

not have to charge tax on their sales and would not be able to claim input tax credits on their business purchases.

The starting point in deriving the estimate is gross sales data for 1990 obtained from personal and corporate income tax information. From this data, one can estimate that the total sales from firms with annual sales of less than $30,000 accounts for approximately 0.5 per cent of all sales in the Canadian economy. This ratio can then be applied to the total gross GST/HST collections to approximate the revenues that would arise from eliminating the small business threshold.

The projected expenditure estimate is based on the growth in nominal gross domestic product (GDP) obtained from the CEFM.

Quick Method Accounting

Objective: *Registrants using the quick method remit a prescribed percentage of GST/HST collected based on their total tax-included taxable supplies for the period. The objective of the quick method is to simplify the operation of the tax for small businesses. (Goods and Services Tax Technical Paper, August 1989.)*

Small businesses registered under the GST/HST are eligible to elect to account for GST/HST using quick method accounting. Under the scheme, businesses do not have to keep track of the tax paid on most of their inputs. Instead, these firms remit a prescribed percentage of the GST/HST that they collect on their sales. The remaining GST/HST collected is kept by the firm in lieu of the unaccounted input tax credits. The firm is eligible to claim an input tax credit for the tax paid on capital goods.

The estimate is derived from micro-statistical data for 1991 supplied by Statistics Canada. The take-up rate of this provision for eligible small businesses is about 22 per cent. The estimate for subsequent historical years is derived by projecting the 1991 estimate based on information on the growth in total input tax credits claimed, which is obtained from the CCRA.

The projected expenditure estimate is based on the growth in nominal GDP obtained from the CEFM.

Water and Basic Garbage Collection Services

Objective: *Consistent with the treatment of standard municipal services, charges for water and garbage collection services are exempt of GST/HST where the property owner has no option but to take the service.*
(Goods and Services Tax Technical Paper, August 1989)

Water and basic garbage collection services are exempt under the GST/HST. The estimate is derived from the Sales Tax Model.

Domestic Financial Services

> ***Objective:*** *Although in some cases, the price of a financial service may be easily identified, in many others, the price is implicit and difficult to isolate. Therefore, for the sake of consistency and equity, all financial services are exempt under the GST/HST. (Goods and Services Tax Technical Paper, August 1989.)*

Financial services are defined to include services relating to financial intermediation, market intermediation and risk pooling. However, in many cases, the price of a financial service is implicit. For example, when banks provide lending and deposit-taking services, the banks' fees for these services are the spread between interest rates received from borrowers and the interest paid to depositors. The exact price associated with each financial transaction is difficult to determine and, therefore, it is difficult to apply the GST/HST to the sale of the service. As a result, most financial services provided to residents of Canada are exempt under the GST/HST.

Members of a "closely related group" (if there is at least 90-per-cent cross-ownership of voting shares between them) where one of the members is a "listed financial institution" could jointly elect to treat most supplies between them as tax-exempt financial services. The purpose of this election is to recognize that a closely related corporate group can be viewed as a single entity with respect to intragroup transactions.

No data are available.

Certain Supplies Made by Non-Profit Organizations

> ***Objective:*** *Public sector bodies, which include charities and non-profit organizations, are organizations that perform essentially a public service function, relying heavily on financial support from governments and the voluntary efforts and contributions of the general public to pursue their efforts. The exemption of supplies made by non-profit organizations recognizes the important role they play in Canadian society. (Goods and Services Tax Technical Paper, December 1989.)*

Supplies that are GST/HST-exempt when made by non-profit organizations include recreational services provided primarily to children age 14 and under and individuals who are underprivileged or have a disability; supplies of food, beverages and lodging to relieve poverty or distress; and certain amateur performances.

No data are available.

Tax Rebates

Housing Rebate

> ***Objective:*** *The new housing rebate program was designed to ensure that the tax does not pose a barrier to the affordability of new homes. Before the GST was introduced, the federal sales tax component of the total price of a new home amounted to approximately 4.1 per cent. With the new housing rebate, new homes are taxed at roughly the same level as they were prior to the GST.*
> *(Goods and Services Tax Consolidated Explanatory Notes, April 1997.)*

Purchasers of newly constructed residential dwellings and substantially renovated houses are eligible for a rebate of the GST/HST paid if the purchaser is acquiring the dwelling as a primary place of residence. For houses priced at or below $350,000, the rebate is 36 per cent of the total GST/HST paid to a maximum of $8,750. The rebate is phased out for houses priced between $350,000 and $450,000.

The estimate for historical years is obtained from Statistics Canada. The projected expenditure estimate is based on the growth in investment in new residential construction obtained from the CEFM.

New Residential Property Rebate

> ***Objective:*** *The GST/HST rental rebate program was designed to alleviate some of the upfront tax liability faced by builders and purchasers of new residential rental property. Introduction of the new rental rebate ensures that builders and purchasers of new residential rental property face the same effective rate faced by purchasers of owner-occupied homes. (Budget, February 28, 2000).*

Builders or purchasers of newly constructed or substantially renovated residential rental property are eligible for a rebate of the GST/HST paid if it can reasonably be expected that the first use of the individual residential units within the property will be for the purpose of renting it for periods of continuous occupancy of at least 12 months as a primary place of residence. The rebate also applies to the construction of new additions to residential rental property and to the leasing of land that is used for residential purposes.

For residential units priced at or below $350,000, the rebate is 36 per cent of the total GST/HST paid to a maximum of $8,750. The rebate is phased out for residential units priced between $350,000 and $450,000.

The rebate will apply to construction, substantial renovation or conversions commencing after February 27, 2000. In the case of leased land, the rebate will apply where the lease agreement is entered into after February 27, 2000.

The initial estimate is derived from two sources: data provided by the Canada Mortgage and Housing Corporation related to the number of units constructed for rental purposes, and data underlying the national accounts provided by Statistics Canada. Moreover, the estimate reflects an allowance for the expected lag between the commencement of construction of a residential rental unit and its completion. In order to determine the forecasted values, the initial estimate was projected using both national accounts and CEFM data.

Rebate for Book Purchases Made by Qualifying Institutions

> ***Objective:*** *The 100-per-cent rebate on books is available to public libraries, schools, universities, public colleges, municipalities, and qualifying charities and non-profit organizations. The special rebate recognizes the important role played by public libraries, educational institutions and other groups in improving literacy levels in their communities. (News Release, October 23, 1996.)*

On October 23, 1996, the Minister of Finance announced that a 100-per-cent rebate would be provided on all book purchases made by public libraries, schools, universities, public colleges, municipalities, public hospitals and qualifying charities and non-profit organizations.

The initial expenditure estimate for 1997 is the estimated annual cost of implementing this provision. The projected expenditure estimate is based on appropriate expenditure data obtained from the CEFM.

Rebate for Foreign Visitors on Accommodation

> ***Objective:*** *The Visitors' Rebate Program provides a rebate to non-residents visiting Canada for GST/HST paid on most goods and short-term accommodation. It also provides rebates for conference-related expenses for conferences attended by non-residents. Its objective is to maintain the attractiveness of Canada as a destination for foreign tourists and conventions. (Goods and Services Tax Technical Paper, December 1989. Press Releases, December 18, 1990 and May 15, 1991.)*

Non-residents visiting Canada are entitled to a rebate for the GST/HST paid on most goods and short-term accommodation. Specifically, the rebate covers the following where the tax paid is at least $20:

- goods for use primarily outside Canada, excluding excisable goods such as alcoholic beverages and tobacco products, provided the goods are exported within 60 days of purchase; and
- the tax paid on short-term lodging, but not including meals, where the period of stay is less than one month.

However, goods for use outside Canada are essentially the same as other exported goods and should be considered as part of the benchmark. Thus, the cost of this provision is only the rebate associated with short-term accommodation.

The CCRA has some administrative data related to rebates paid on short-term accommodation to foreign visitors. However, this data only partially captures the provision's associated tax expenditure, since it is not possible to identify the value of rebates that are conferred to travel operators and which are included in the business's input tax credit. Hence, the estimate of the tax expenditure for short-term accommodation is based on CCRA administrative data, supplemented with additional data on foreign visitors provided by Statistics Canada.

MUSH Sector Rebates

> ***Objective:*** *Since municipalities, universities and public colleges, schools and hospitals (MUSH) provide primarily tax-exempt services, they are unable to claim input tax credits for GST/HST paid on most of their purchases. However, these organizations are entitled to partial GST/HST rebates.*
>
> *The MUSH rebate system was established to ensure that the sales tax burden of these entities did not increase as a result of moving to the GST from the previous federal sales tax. (Goods and Services Tax Technical Paper, August 1989.)*

Rebates for Municipalities

Recognized municipalities are entitled to a rebate of 57.14 per cent of the GST/HST paid on their purchases used in the course of supplying exempt municipal services.

Rebates for Hospitals

Public hospitals are eligible for a rebate of 83 per cent of the GST/HST paid on purchases related to their supply of exempt services.

Rebates for Schools

Elementary and secondary schools operating on a not-for-profit basis are eligible for a rebate of 68 per cent of the GST/HST paid on purchases related to their supply of exempt services.

Rebates for Universities

Recognized degree-granting universities operating on a not-for-profit basis are eligible for a rebate of 67 per cent of the GST/HST paid on purchases related to their supply of exempt services.

Rebates for Colleges

Public colleges that are funded by a government or municipality and whose primary purpose is to provide vocational, technical or general education are eligible for a rebate of 67 per cent of the GST/HST paid on purchases related to their supply of exempt services.

The estimate of MUSH rebates for historical years is based on data from the CCRA. Since the value of the tax expenditure is influenced by provincial budgetary decisions, the projected value of the tax expenditure for the relevant years is simply the value estimated for 1998.

Rebates for Charities and Non-Profit Organizations

> ***Objective:*** *Registered charities are eligible to claim a 50-per-cent rebate of the non-creditable GST/HST paid on purchases relating to their non-commercial activities. Other non-profit organizations may also claim the rebate, provided they receive at least 40 per cent of their funding from government. The objective of the rebate is to effectively reduce GST/HST costs for these groups, in recognition of the important role they play in Canadian society. (Goods and Services Tax Technical Paper, December 1989.)*

Charities

Charities registered under the Income Tax Act are eligible for a rebate of 50 per cent of the GST/HST paid on purchases related to their supplies of exempt services.

Non-Profit Organizations

The organizations eligible for the non-profit organizations rebate are government-funded non-profit organizations. They include registered amateur athletic associations and organizations operating a facility or part thereof to provide nursing home intermediate care or residential care, and which receive at least 40 per cent of their funding from governments, municipalities or Indian bands. These organizations are eligible for a rebate of 50 per cent of the GST/HST paid on purchases related to their supplies of exempt services.

The estimate of GST/HST rebates for charities and non-profit organizations for historical years is based on data from the CCRA. Since the expenditures of non-profit organizations are captured in Statistics Canada's definition of personal expenditures, the projected estimate is based on the growth in consumer expenditures obtained from the CEFM.

Tax Credits

Special Credit for Certified Institutions

> ***Objective:*** *Under the former federal sales tax, certain organizations certified by Revenue Canada (now the CCRA) that employed people with mental or physical disabilities were exempt from paying or charging sales tax on materials and manufactured goods, respectively. Under the GST, a transitional GST credit was introduced to allow certified institutions time to adapt to the new GST environment. Under the transitional measure, certified institutions were to retain a proportion of the tax collected on their sales. The deductible portion was 100 per cent for 1991, 75 per cent for 1992, 50 per cent for 1993, and 25 per cent for 1994 and 1995, the last year of the transitional program.*
> *(Goods and Services Tax Consolidated Explanatory Notes, April 1997.)*

A special credit was provided for the period January 1, 1991 to the end of 1995 to certified institutions that employed mentally or physically disabled individuals in the manufacturing of goods. These institutions were treated in the same manner as other businesses under the GST. However, they received a special credit calculated on the basis of 100 per cent of the GST collected from sales on manufactured goods in 1991, 75 per cent in 1992, 50 per cent in 1993 and 25 per cent in both 1994 and 1995.

No data are available.

GST/HST Credit

> ***Objective:*** *The refundable GST/HST low-income credit was established to replace the former sales tax credit in place under the previous federal sales tax and to offset the introduction of the GST. At the time of its introduction, the credit was enhanced for single parents and single individuals and the threshold at which benefits begin to be reduced was increased. The objective of the credit is to improve the fairness of the sales tax system. (Goods and Services Tax Technical Paper, August 1989.)*

When the GST was first introduced, a credit was established to ensure that families with annual incomes below $30,000 would be better off under the new sales tax regime. The amount of the GST/HST credit depends on family size and income. Currently, the basic adult credit is $199. Families with children aged 18 and under receive a basic child credit of $105 for each child. However, single parents can claim a full adult credit of $199 for one dependent child. In addition to their basic credit, single adults (including single parents) are eligible for an additional credit of up to $105. The value of the credit is reduced for families with incomes over $25,921. As a result of the 2000 federal budget, both the credit amounts and the income threshold are adjusted annually to increases in the consumer price index.

The estimate for historical years is based on data from the CCRA. The projected expenditure estimate is obtained from the Department of Finance Canada's fiscal forecast.

Memorandum Items

Meals and Entertainment Expenses

> ***Objective:*** *As is the case for income taxation, meals and entertainment expenses involve an element of personal consumption and therefore some part of their cost can properly be characterized as a personal expense that should not result in input tax credits.*

In the normal operation of the GST/HST, registrants are allowed to claim full input tax credits for the tax paid on their purchases. However, in the case of the tax paid on meals, beverages and entertainment expenses, the registrant is allowed to recover only 50 per cent of the GST/HST paid as an input tax credit. (Prior to February 1994, the input tax credit for business meals and expenses was 80 per cent.) There is no input tax credit allowed for the GST/HST paid on membership fees or dues in any club whose main purpose is to provide dining, recreational or sporting facilities.

The estimate is based on the cost of the meals and entertainment tax expenditures contained in the personal and corporate income tax expenditure tables. These figures are first grossed up to arrive at the total meals and entertainment expenses in the entire economy using the marginal federal income tax rates by sector. Then, 15 per cent is removed to account for expenses incurred in GST/HST-exempt activities since they are ineligible for any input tax credits. The cost of this provision is equal to the above net expenses multiplied by 7 per cent.

Rebate to Employees and Partners

> ***Objective:*** *Many employees and partners who are not registrants incur expenses in the course of carrying out their duties that may not be directly reimbursed by their employers and partnerships. Instead, compensation is usually provided through salaries, commissions, profits and other means that would not be subject to tax. Consequently, employers and partnerships cannot recover the GST/HST paid by the employees and partners.*
>
> *The employee and partner rebates recognize these existing business practices and attempt to reduce the possible tax cascading effect that otherwise would occur in the absence of the rebates. (Goods and Services Tax Technical Paper, August 1989.)*

A rebate is available to certain employees of a GST/HST registrant for the GST/HST paid on those expenses that are deductible in computing the employee's income from employment for income tax purposes. For example, an employee is allowed to claim a rebate equal to 7/107ths (or 7/115ths in a participating HST province) of the capital cost allowance on an automobile, aircraft or musical instrument that is used in his or her employment and on which GST/HST is payable. Also, the GST/HST rebate is available to an individual who is a member of a GST/HST-registered partnership in respect of expenses incurred outside the partnership that are deducted in computing the member's income from the partnership for the purposes of the Income Tax Act.

The estimate for historical years is based on data from the CCRA. The projected expenditure estimate is based on the growth in nominal GDP obtained from the CEFM.

Residential and Other Personal-Use Real Property

> ***Objective:*** *The objective of the housing rebates and exemptions for used homes and redidental rents is to preserve the affordability of housing while ensuring that the tax regime is not overly complex.*
> *(Goods and Services Tax Technical Paper, August 1989.)*

Generally, the GST/HST applies to residential property when it is first purchased or leased and occupied by an individual. All subsequent sales of used homes are tax-exempt. The exemption for personal-use real property is consistent with the tax treatment of personal property and services not supplied in the course of commercial activities.

Real property transactions exempt under the GST/HST include sales of used residential property, sales of personal-use real property by an individual or a personal trust, and the sale of farmland to a family member who is acquiring the property for personal use.

No data are available.